THE BIGGEST TAX PROBLEMS FOR SMALL BUSINESSES

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HOUSE COMMITTEE ON SMALL BUSINESS

CONTENTS

OPENING STATEMENTS

	Page
Hon. Sam Graves	1
Hon. Nydia Velázquez	2

WITNESSES

Mr. David Kautter, Managing Director, Kogod Tax Center, Kogod School of Business, American University, Washington, DC	3
Mr. Tim Reynolds, President, Tribute, Inc., Hudson, OH, testifying on behalf of the National Small Business Association	5
Mr. Rick Endres, President, The Washington Network, Inc., Alexandria, VA, testifying on behalf of the ASCII Group	6
Mr. Donald Marron, Institute Fellow and Director of Economic Policy Initiatives, The Urban Institute, Washington, DC	8

APPENDIX

Prepared Statements:	
Mr. David Kautter, Managing Director, Kogod Tax Center, Kogod School of Business, American University, Washington, DC	27
Mr. Tim Reynolds, President, Tribute, Inc., Hudson, OH, testifying on behalf of the National Small Business Association	39
Mr. Rick Endres, President, The Washington Network, Inc., Alexandria, VA, testifying on behalf of the ASCII Group	50
Mr. Donald Marron, Institute Fellow and Director of Economic Policy Initiatives, The Urban Institute, Washington, DC	55
Questions for the Record:	
None.	
Answers for the Record:	
None.	
Additional Material for the Record:	
The National Association for the Self-Employed (NASE) submitted by Katie Vlietstra, Vice-President of Government Relations & Public Affair	67
Sageworks submitted by Brian Hamilton, Chairman & Co-founder	70

THE BIGGEST TAX PROBLEMS FOR SMALL BUSINESSES

WEDNESDAY, APRIL 9, 2014

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 1:00 p.m., in Room 2360, Rayburn House Office Building. Hon. Sam Graves [chairman of the Committee] presiding.

Present: Representatives Graves, Chabot, Luetkemeyer, Tipton, Hanna, Schweikert, Bentivolio, Collins, Velázquez, Schrader, Chu, Hahn, Payne, Meng, Schneider, and Barber.

Chairman GRAVES. Good afternoon. I call this hearing to order.

Next Tuesday, April 15, Americans will once again file their annual income tax returns. For small business owners, Tax Day is yet another reminder of the many burdens of the tax laws. They bring a never-ending parade of higher rates, increased complexity, and ever-changing regulations.

If you talk with small business owners often, as members of the Committee do, you know that individually they may be affected by one particular part of the tax law or another. But taken together, small business owners consistently tell us that they are impacted by higher taxes, new taxes, increasing tax code complexity, uncertainty, and the additional time required to resolve issues with the Internal Revenue Service. All of this means they have little ability to plan with confidence, and less time to grow their companies.

One tax preparer for small businesses recently called this cumulative effect "death by a thousand cuts." We know that small businesses face unique tax challenges, because research have shown that it is more costly and time consuming for small firms to comply with the tax code. But while most Americans may think about taxes once a year, entrepreneurs cope with multiple tax issues each day in operating their businesses.

In connection with today's hearing, the National Small Business Association (NSBA) is releasing its annual Tax Survey of Small Businesses. The survey confirms that entrepreneurs are spending scarce resources on federal tax compliance. About half (49 percent) are spending $5,000 or more per year on tax compliance—not including tax owed. Forty percent more spend more than 80 hours per week dealing with federal taxes, and 86 percent pay an external tax preparer to handle their taxes. The overwhelming majority (73 percent) said federal taxes have a significant impact on the day-to-day operation of their businesses. We are going to hear more

about the survey results shortly form Tim Reynolds, who is one of NSBA's members.

Today, we hope to learn more about all of these tax issues. I want to thank all of our witnesses for being here. We look forward to hearing your testimony. And I now turn to Ranking Member Velázquez for her opening statement.

Ms. VELÁZQUEZ. Thank you, Chairman Graves.

With April 15th just around the corner, most Americans are wrapping up their paperwork. Yet, for many small business owners, the process never really ends. Constant changes to the tax code make compliance a year-round challenge for small employers.

This is not the first time our Committee has discussed tax challenges facing small firms. The Small Business Committee has held numerous hearings examining how specific provisions like bonus depreciation and estate tax affect entrepreneurs. Yet, the most frequent complaint we hear from small employers is how our current tax system creates uncertainty, hindering long-term business planning and growth.

This uncertainty is the product of a complex and outdated tax code. As we all know, complexity adds significantly to the cost of tax compliance for small firms. Modernizing this system will provide simplicity, fairness, and predictability to businesses of all sizes. That is why I am glad that the Senate has taken measures to actively extend almost all 55 extenders that expired last year. Now, we must give small firms some certainty that they will operate under this rule for the foreseeable future. More broadly, tax law operates best when small businesses have long-term certainty and stability. This is why fundamental tax return is imperative.

One tax reform goal should be promoting growth and job creation. Small businesses are a vital part of that equation. Too often, entrepreneurs' tax reform priorities are drawn out in the larger debate. I expect today's discussion will yield recommendations that will be helpful as we work together to improve the tax environment for small firms.

Although some existing tax policies provide critical relief to small firms, much of the code is riddled with inequities and unnecessary complexities. For small entities, this creates obstacles to success rather than encouraging economic growth. It is important that we continue working toward a comprehensive overhaul of the tax code rather than a corporate-only approach. Doing so supports our nation's job creators by allowing them to continue hiring and expanding without warning about annual changes. Most importantly, any agreed-upon plan must ensure the extension of critical business expenditures.

One critical provision is enhanced business expensing, sometimes called Section 179. The majority of small firms we have spoken to insist that this specific item must be retained. It encourages small entities to make purchases now while also putting more money in their pockets to invest and hire.

One thing is clear about tax reform—small firm needs must come first. No matter the approach taken, the small business community wants their voice to be heard. We cannot move forward without their input, and we must recognize the impact of how any proposals will affect them. I believe there exists an opportunity to im-

plement long-lasting reforms. Doing so will have immediate benefits to small businesses.

With that, I just want to take this opportunity to thank all the witnesses for being here today and providing insightful information regarding the tax code and small businesses.

Thank you, Mr. Chairman.

Chairman GRAVES. All right. Our first witness is David Kautter, who is the managing director of Kogod Tax Center at American University here in Washington, D.C. Kogod Center provides research on the tax problems of small businesses. Previously, Mr. Kautter was the national director of tax for Ernst & Young.

Thank you for being here.

STATEMENTS OF DAVID KAUTTER, MANAGING DIRECTOR, KOGOD TAX CENTER, KOGOD SCHOOL OF BUSINESS, AMERICAN UNIVERSITY; TIM REYNOLDS, PRESIDENT, TRIBUTE, INC.; RICK ENDRES, PRESIDENT, THE WASHINGTON NETWORK, INC.; DONALD MARRON, INSTITUTE FELLOW AND DIRECTOR OF ECONOMIC POLICY INITIATIVES

STATEMENT OF DAVID KAUTTER

Mr. KAUTTER. Chairman Graves, thank you very much. Ranking Member Velázquez and members of the Committee, thank you for the opportunity to testify today. My name is David Kautter, and I am the managing director of the Kogod Tax Center located at American University. The Kogod Tax Center is a tax research institute dedicated to nonpartisan research on tax matters affecting small businesses, entrepreneurs, and middle income tax payers.

I have been a tax practitioner for over 40 years. As the chairman mentioned, prior to joining the Kogod Tax Center, I was director of National Tax for Ernst & Young. Over the course of my career, I have watched with great disappointment as the Internal Revenue Code has grown increasingly complex in its structure, incomprehensible in its nature, and pervasive in its effect on business decision-making. There is little doubt that the nearly paralyzing complexity, overwhelming length and constantly changing nature of our federal tax laws are having a profound effect on small business decision-making and impeding their ability to grow and create jobs.

Based on surveys we have conducted over the past three years, discussions with small business owners and personal experience as a tax account, it is clear to me that the two biggest tax problems facing small business today are one, complexity, and two, the constantly changing nature of the tax law. These two forces show up in many ways, but there are seven particularly critical problems they are creating for small businesses today.

First and foremost, most small businesses have given up trying to understand the tax law, and they have outsourced their tax planning and their compliance. It is estimated that close to 91 percent of small all businesses hire a tax return preparer at a cost of around $16 billion a year.

Second, because the tax laws changes so often, small businesses are making decisions without full knowledge of their economic consequences. According to our surveys, the single-most important area of tax uncertainty for small businesses involves that men-

tioned by Ranking Member Velázquez, how much equipment can be immediately deducted, and what has to be depreciated. These rules need to be settled.

Third, constantly changing tax laws mean constantly changing tax filing requirements, which means constantly changing recordkeeping requirements, which means constantly growing uncertainty, inefficiency, and frustration. The number one factor cited in Kogod Tax Center surveys that is contributing most to increased cost is the constantly changing rules and regulations.

Fourth, increasing tax recordkeeping, tax compliance, and tax reporting requirements are diverting increasing amounts of time away from operating and growing small businesses.

Fifth, internal costs. Despite spending $16 billion a year on outside tax return preparation, it is estimated that annually small businesses spend more than 2.5 billion hours of their own time on federal tax matters. This is not a healthy state of affairs.

Sixth, tax compliance is becoming a year-round activity, requiring more interaction with the IRS. Yet, many small business owners say it is difficult to get answers from the IRS and solving problems takes more time.

Finally, there are several specific areas of the tax law that are particularly challenging for small businesses. The top six are the rules governing accounting methods, depreciation, inventory, employee independent contractor determinations, the healthcare law, and retirement plans. Simplification of these rules is critical.

Given all this, I would like to put forward two proposals that will not solve all the problems of small business but they will help a lot when it comes to taxes. The first is called the simplified cash method. This proposal would allow businesses with up to $10 million in revenue to immediately deduct all amounts they spend to run their business. That would include amounts they spend for inventory, capital equipment, wages, materials, supplies, everything. You could think of it as a checkbook method of accounting because taxable income would be based on cash received and cash paid. No inventory rules. No depreciation rules. No capitalization rules. Just cash flow. It is simple and it could work.

My second proposal is not so much as simplification proposal as an equity proposal. It makes little sense to me that corporations are taxed at 35 percent and small businesses are taxed at rates as high as 39.6 percent. My proposal is that all business income be taxed under a single business tax rate schedule, no matter whether it is earned by a sole proprietor, a partnership, or a multinational corporation. It could be a graduated rate scale, but I would propose that it be the same rate scale for all business income. This could be easily implemented because small businesses already report the information needed to compute tax on a unified business tax rate scale on their existing tax return.

Mr. Chairman, that concludes my prepared remarks. Thank you for allowing me to testify today, and I would be delighted to answer any questions.

Chairman GRAVES. Thank you very much.

Our next witness is Tim Reynolds, who is the president of Tribute, Inc., in Hudson, Ohio. Prior to purchasing Tribute, Mr. Reynolds held several positions with British Petroleum and BP Amer-

ica. He is a first vice president of the National Small Business Association, and he is testifying today on its behalf.

Thanks for being here, Mr. Reynolds.

STATEMENT OF TIM REYNOLDS

Mr. REYNOLDS. Good afternoon. I would like to thank Chairman Graves and Ranking Member Velázquez, and the members of the Small Business Committee for inviting me to testify today.

I am Tim Reynolds, owner and president of Tribute, Inc., a software company located in Hudson, Ohio. Our 38-employee company develops and markets software for industrial distributors. We provide a fully integrated distribution management system supporting virtually all of the distributors' business system needs.

I am proud to be here representing not only my own company, but also the National Small Business Association. NSBA is the nation's first small business advocacy organization. NSBA is uniquely member driven and a staunchly nonpartisan organization. I serve as vice chair.

I would like to focus my remarks this afternoon on two of the major themes that emerged from a recent survey of our members at NSBA—the need for consistency and the importance of predictability.

Our 70,000 page tax code has become disorganized by its own complexity. This complexity has real world implications. Nearly one in three small businesses spend more than $10,000 per year on the administration of federal taxes. This is just the accounting fees and so on before they pay their tax liabilities. This money would be better spent toward hiring a new employee or growing the business.

The tax code is a patchwork quilt of internally inconsistent and often conflicting measures and objectives. For example, as a software development company, Tribute spends a significant amount of time, money, and resources each year on research and development. As such, we are entitled to take advantage of the R&E tax credit, which can produce significant tax savings and allow innovative companies such as mine to increase their R&D efforts. However, because we are a sub S corporation, like the majority of small businesses, the income of the business passes through to my personal income taxes. I am almost always subject to the Alternative Minimum Tax. This effectively prevents my company from taking the R&E credit.

Small businesses are often America's greatest innovators, and yet the complicated tax code steps on its own foot in this area. Even if I wanted to take the R&E tax credit, I cannot because on December 31st of last year it expired, along with 55 other tax provisions commonly referred to as tax extenders. Seventy-three percent of our members report using one or more of these incentives. While most of these tax incentives have been extended several times in recent years, it often has been done retroactively and in a rushed manner, leaving many small businesses scratching their heads on how to plan for the upcoming year. By Congress continuing to further delay the extensions, it punishes our work, investment, risk-taking, and entrepreneurship.

Another important example of this problem is the uncertainty around Section 179. 179 expensing is of vital importance for small-

er firms, particularly those involved in more capital-intensive industries. More than one in three NSBA members take advantage of this break as it encourages small businesses to invest in new equipment by letting them expense much of the cost up front instead of depreciating it over time.

For Tribute, it has its largest impact on my sales. The software we sell is typically my customers' second largest investment behind only that of their inventory, and as such, it is eligible for the benefits allowed under Section 179. This deduction is often the difference between affordable and not, and our customers often plan several years in advance for this very significant purchase and implementation. The annual termination, change in limits, and delayed extensions of this and other tax extenders disrupts this planning, interferes with business efficiency improvements, and harms the economy, both for buyers and sellers of capital goods.

In conclusion, the complexity, unpredictability, and inconsistency within the tax code poses a significant and increasing problem for small business. The ever-growing patchwork of credits, deductions, tax hikes, and sunset dates is a rollercoaster ride without the slightest indication of what is around the next corner. The tax code is unfair to small businesses, biased against savings and investment, and impossibly complex. We need a tax system dedicated to investment, savings, and small business growth.

Again, I would like to thank Chairman Graves and Ranking Member Velázquez, and the members of the Small Business Committee for the opportunity to speak today. I would be very happy to answer any questions that you have.

Chairman GRAVES. Thank you, Mr. Reynolds.

Our next witness is Rick Endres, who is the president of The Washington Network, Inc., in Alexandria, Virginia. Mr. Endres founded his company in 1987 to design and implement computer network systems for small- and medium-sized businesses. He is testifying today on behalf of ASCII Group.

Thanks for being here.

STATEMENT OF RICK ENDRES

Mr. ENDRES. Good afternoon, Chairman Graves, and Ranking Member Velázquez, and distinguished members of the Committee.

I am Rick Endres. I appear on behalf of my company, The Washington Network, Inc., and a member of the ASCII Group, which is the nation's oldest community of small- and medium-sized IT companies.

Thank you for holding this hearing on tax issues that face small business and gives me the opportunity to share my company's experience with the tax code. This topic resonates with me because of the increasing complexity of the tax code and the difficulty we have in complying with it. These are challenges that we, small business owners, face on a regular basis.

Now, my company, The Washington Network, is an IT consulting firm that installs and supports computer systems and computer networks, telephone systems in businesses throughout the Washington, D.C. area. And during our 27 years in business, we have provided IT technical support to hundreds of companies and employed dozens of people. Yet, I have found that the complexity of

the tax code has had a very negative effect on both my firm's growth and my hiring ability. This is true even for areas of the code that were meant to stimulate job growth. Tax credits designed to help businesses like mine often go unused because of the time and cost required to take advantage of them.

Now, I should point out that I am not a tax authority. I am not a CPA, nor do I wish to be. But I am sitting before you today just telling you a few tales from the frontlines of business, describing some of the skirmishes that I have had with the tax code.

The first skirmish was with the Veterans Hire Tax Credit, which encourages us to hire unemployed veterans. That is a really worthy incentive; however, this little known credit takes a number of billable hours to comply with, and then if you do not file its Form 8850 within 28 days of hiring the veteran, you are disqualified from the credit. Now, this unrealistic compliance timeframe makes pursuing the Veteran Hire credit really unworkable, and so we have to pass. Not that we would not hire veterans, but we would not take advantage of the credit.

Now, the Small Employer Health Insurance Credit and its 10-page Form 8941, is my poster child for needless complexity. The amount of information that I have to assemble to even see if I qualify for this credit is mindboggling. In 2007, the IRS calculated over 30 hours to comply with this credit. In tax year 2013, they said it would be less than 15 hours. Now, my accountant can do it in 10 hours, but why would I pay him $1,500 for a $500 tax credit? Why not just say if you are a small business under 25 employees and the people you hire you supply health insurance for them, you give a 10 percent credit? That is easy to understand and the credit would help. But when you study the form, the pages and pages of complexity, you realize—the term Rube Goldberg comes to mind, which is a very complex machine that you put $1,500 into and $500 comes out the bottom end. The only beneficiaries of this credit are the accountants.

Now, if you are a sub-chapter S corporation, like my company is, the tax code does not allow keeping any retained earnings in the business, which can be used for rainy day or to fund future growth. This is a capital formation disincentive. It does not make any sense. There needs to be a portion of the K–1 that is not taxed at the highest rates.

There are unintended consequences in the tax code that have a chilling effect on the number of employees that I will hire. Although our employee count has varied over time, we never planned to grow beyond 30 employees in an effort to stay under the regulatory and tax code radars. I know a number of companies have taken a great deal of time and money to split their companies in two to avoid head counts over 50. The money that they have spent to avoid these punitive thresholds adds nothing to these companies' ability to improve their products or increase their competitiveness.

So as you can see, because of the punitive tax code, I have to siphon off vital time and capital out of my company simply to comply. From my experience, if we had a simpler, less complicated tax code, it would allow an entrepreneur, such as myself, to invest more of my time, more of my resources into the company, to grow the business, and create more jobs.

Thank you.

Ms. VELÁZQUEZ. Yes. It is my pleasure to introduce Dr. Donald Marron. Dr. Marron is the director of Economic Policy Initiatives at The Urban Institute. Since joining The Urban Institute as director of the Urban Brookings Tax Policy Center, his work has focused on tax reform and America's fiscal challenges. He has previously served as a member of the President's Council of Economic Advisors, acting director of the CBO, and executive director of Congress's Joint Economic Committee.

Welcome, Dr. Marron, and thank you for being here.

STATEMENT OF DONALD MARRON

Mr. MARRON. Thank you so much. Hi, everybody. Chairman Graves, Ranking Member Velázquez, members of the Committee. Thank you for inviting me to appear today to discuss the tax challenges facing small business.

America's tax system is needlessly complex, economically harmful, and often unfair. Despite recent revenue gains, it likely will not raise enough money to pay the government's future bills. The time is thus ripe for wholesale tax reform. Such reform could have far-reaching effects, including on small businesses. To help you think about those effects, I would like to make seven points about the tax issues facing small business.

First, as everyone on the panel here has mentioned, tax compliance places a large burden on small businesses, both in the aggregate and relative to large ones. The IRS estimates that businesses with less than $1 million in revenue bear almost two-thirds of business compliance costs and compliance costs are much larger relative to revenues or assets or any measure of firm size for small firms and for big ones.

Second, small businesses are also more likely to underpay their taxes. Because they often deal in cash and engage in transactions that are not reported to the IRS, small businesses can understate their revenues and overstate their expenses, and thus underpay their taxes. Some underpayment is inadvertent, reflecting the difficulty of complying with our complex and ever-changing tax code, and some is intentional. High compliance costs disadvantage responsible small businesses, while the greater opportunity to underpay taxes advantages less responsible ones.

Third, as also mentioned here, the current tax code offers small businesses several advantages over larger ones. Provisions such as Section 179 expensing, cash accounting, graduated corporate tax rates, and special capital gains tax benefits benefit businesses that are small in terms of investment income or assets.

Fourth, several of those advantages expired at the end of last year, and thus are part of the current tax extenders debate. These provisions include expanded eligibility for Section 179 expensing and larger capital gains exclusions for investments and qualifying small businesses. Allowing these provisions to expire and then retroactively resuscitating them is a terrible way to make tax policy. If Congress believes these provisions are beneficial, they should be in place well before the start of the year so businesses can make investment and funding decisions without needless uncertainty.

Fifth, many small businesses also benefit from the opportunity to organize as pass-through entities such as S corporations, limited liability companies, partnerships, and sole proprietorships. These structures all avoid the double taxation that applies to income earned by C corporations. Some large businesses adopt these forms as well, and account for a substantial fraction of pass-through economic activity. Policymakers should therefore take care not to assume that all pass-throughs are small businesses.

Sixth, tax reform could recalibrate the tradeoff between structuring as a pass-through or as a C corporation. Many policymakers and analysts have proposed revenue neutral business reforms that would lower the corporate tax rate while reducing tax breaks. Such reforms would likely favor C corporations over pass-throughs since all companies could lose tax benefits while only C corporations would benefit from the lower corporate tax rate.

Finally, tax reform could shift the relative tax burden of small and large businesses. Some tax reforms would reduce or eliminate tax benefits aimed at small businesses, such as graduated corporate rates. Other reforms, for example, lengthening depreciation and amortization schedules for investments or advertising but allowing safe harbors for small amounts, would increase the relative advantages that small businesses enjoy. The net effect of tax reform will thus depend on the details and may vary among businesses of different sizes, industries, and organizational forms. It also depends on the degree to which lawmakers use reform, a much needed opportunity to reduce compliance burdens on small businesses.

Thank you. I look forward to your questions.

Chairman GRAVES. Thank you all very much. We are going to start questions with Mr. Hanna.

Mr. HANNA. Mr. Marron, you mentioned vaguely the underground economy. Has anyone here done any measurements on what that might look like knowing that complexity cost associated with complying, all of the things are a very direct incentive for people to run their businesses under the radar as much as possible?

I am curious. There are other countries around the world that have huge problems with underground economies, and yet they still have lower rates than us. Maybe, Mr. Marron, you could talk about that a little bit, or anyone.

Mr. MARRON. Certainly. I would be happy to take first crack.

The IRS periodically does studies where it tries to estimate the size of the tax gap, and one of the things that they try to include in that is the informal economy. If you think about it, the informal economy in broad strokes has two pieces to it. One is otherwise legitimate activities that people may do on a cash basis in order to avoid taxes. A canonical example would be a contractor that you pay in cash rather than having anything that is traceable, but then also caught up in that are things that are the illegal parts of the economy. And, obviously, one would I think feel about them quite differently from the legal parts.

Other nations face similar problems. As you say, they often have lower rates. In part that is because we, as a nation, focus quite heavily on income taxes as a basis for our overall tax system, while

many other nations have things like value-added taxes. They raise some different compliance issues, but often allow them to have——

Mr. HANNA. Do the value-added taxes tend to be more efficient and more collectible, if you will?

Mr. MARRON. So value-added taxes tend to be a more efficient way of raising tax revenue, and I think that is one of the reasons why you see nations that have larger governments tend to rely on them for a significant portion of revenues.

Mr. HANNA. Because it is harder to escape.

Do you have an estimate on the size? What is the last estimate you saw by anyone on the size of the underground economy? The reason I ask that is there is a lot of class conversation about, you know, who makes a lot of money and how much they should pay. And I am not weighing in there for the moment, but there is also the possibility there are a great many people who should pay something who are paying nothing. And that is equally unfair. And I know we are making the problem worse, but the burden falls on the people that are in your businesses.

I was in business for 30 years. I worked, strived to be legitimate, paid everything I had to pay legally. And there is within that, I would say personally, you begin to have a certain resentment when you look around you and so many people are working in cash and employees are working under the table and that kind of thing. And you see it growing because we are actually incentivizing it.

Does anybody want to talk about that?

Mr. KAUTTER. Congressman, I will respond to that briefly.

At one point I tried to find any data on how much noncompliance is intentional, how much is unintentional. It does not exist. I think a lot of the mistakes that are made, the tax gap, are people that genuinely want to comply but cannot figure it out. And second, the Taxpayer Advocate Service recently did a study on small business and underpayment of taxes, and one of the critical factors that the Taxpayer Advocate Office found is norms; that different parts of the country have different cultures. And when you get a small business culture where folks are complying, other small businesses tend to comply.

Mr. HANNA. Sure. It looks like, too, that people whose W–2s are reportable and they cannot avoid it, I mean, they are really the victims in this. I know as a business guy you have opportunities with depreciation and all the things we talked about to kind of move things around legally. But yet the people, like a school teacher or someone who works in any job, right, they have none of those capacities. Well, that is right. They are not breaking the law; that is a good thing. But it is not just unfair to upper class and middle class people; it is unfair to reporters, and to people who report and have no choice. And I wonder if anecdotally you hear what I do on the ground and people are just sick of it.

Mr. KAUTTER. I do hear that frankly a lot at the Tax Center, and when it comes to information reporting, the percentage of wages that are reported is over 99 percent because the IRS gets a W–2, usually gets it electronically.

Mr. HANNA. Or 1099 or whatever.

Mr. KAUTTER. And the 1099 is very high as well. It is in the 90s. It is the transactions that are not reported that tend to create the gap.

Mr. HANNA. So yes or no. I am going to run out of time. Have you had a chance to look at the Ways and Means, Mr. Camp's proposals? It is a great attempt at kind of cleaning out a lot of things. It is a starting point; right?

Mr. KAUTTER. I would say that it is. It broadens the base and lowers the rate. It is not simple. It is not simple.

Mr. HANNA. Not as simple as what you talked about when you opened up.

Thank you. My time is expired.

Ms. VELÁZQUEZ. Dr. Marron, there has been a movement away from organizing C corporations in favor of pass-through entities. Today, corporate tax revenue makes up less than 10 percent of our federal revenue. What is it about pass-through entities that make them such an attractive business structure?

Mr. MARRON. Oh, wow. I suppose I should lead off by saying that I think in my time I, myself, have formed three of them. And one thing that is very attractive about them is just how easy it is relative to other forms, in particular for myself setting up an LLC. You know, there is some paperwork involved, but relative to the standards of setting up a C corp or something it is very simple. You can get in business quickly.

And another major thing is the tax treatment. The ability to be structure as a pass-through, pay the taxes on your individual income tax, and thereby avoid the double taxation of the corporate tax is very attractive and very beneficial for small businesses.

Ms. VELÁZQUEZ. Thank you.

Mr. Kautter, it is pretty hard to argue, and I made the statement in my opening statement, that the system is not just overwhelmingly complex. One of the main problems for businesses is deciding which tax structure offers the most advantages. Do you believe businesses simply have too many tax options on the table which make tax law more complicated?

Mr. KAUTTER. You know, that is a good question, Congresswoman. And I think the law is complicated by the range of options that are available. Now, those options have grown out of more illegal concern on how to protect assets and do it flexibly, but for tax purposes, we do not have to recognize if we did not want to all those different structures. We could come up with some basic ways in which any form of business would be taxed, and that could simplify things.

Ms. VELÁZQUEZ. Okay. So one of the distinguishing features of our system is affording businesses to option to choose how to organize themselves based on what best suits their capital requirements and their management needs. Why is it that this flexibility is so important to the health of the U.S. economy?

Mr. KAUTTER. Well, I think that from a legal point of view, being able to structure your affairs in an efficient manner is very important. The tax consequences become part of that equation. And the ability to avoid two levels of tax is absolutely critical in most discussions when it comes to small business. The idea of operating a corporation, having to worry about the C corporation rules, divi-

dends, two levels of tax, it is just impractical. Very, very few small businesses.

Ms. VELÁZQUEZ. You, yourself, you are one of the proponents of suggesting moving to an integrated tax system. Would you explain how such a system will work? And in transitioning to such a system, will we add more complexity?

Mr. KAUTTER. I think the greatest single thing that can be done for simplicity for small business is a simple cash method of accounting. And I think you can institute that without integrating corporate and individual taxes.

My second proposal is that no matter which business form a business decides to use, maybe we should just have a single tax rate schedule for all business—sole proprietors, partners, corporations. It is one business rate schedule, and so you do not have corporate income taxed at 35 and income from a sole proprietorship taxed at 39.6. And it is easy because the information is already on the tax returns. Schedule C is sole proprietorships. Schedule E is S corporations. You just add them together.

Ms. VELÁZQUEZ. Thank you.

Mr. Reynolds, my last question. I have to go to the floor now.

Experts agree that to make the U.S. more competitive we need to lower our corporate tax rate, and some have suggested a piecemeal approach to tax reform. However, I am hesitant to enact corporate-only reform because small businesses are so passionate about finally enacting tax reform. If corporate-only reform were the only option, would you consider it or would you insist on a comprehensive tax plan?

Mr. REYNOLDS. For the vast majority of small businesses, including my own company, they are pass-through entities. And as was pointed out earlier, if you do just C corporation reform, what happens then is that a company such as mine loses the many tax incentives that would be struck during that reform, but then ends up not benefitting from the lower rates. As a result, we would be put at a disadvantage relative to larger corporations and frankly, small businesses have enough disadvantages. So it would be very difficult for us to support that.

Ms. VELÁZQUEZ. Thank you.

Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Bentivolio.

Mr. BENTIVOLIO. Thank you very much, Mr. Chairman.

Every year around this time it seems like my wife and I are spending a lot of time together going through receipts and documents and files and bank statements, credit card statements to put everything together so we can take it to the accountant. It seems to me it should be simpler and more fair.

Just yesterday, coincidentally, a colleague of mine on the floor of Congress, we were talking about the variable added tax. A colleague from New York.

Dr. Marron, you know, it was my understanding the VAT basically taxes every stage a product will go through. For example, from the farmer who buys the wool, to the sweater maker, to the retailer, and then to the consumer. There is a 20 percent or 10 percent, whatever that rate is is added. Is that right? Is that how it works?

Mr. MARRON. It works like that but the tax only applies to the value-added added at each stage. So it is the incremental value along the way that gets that rate.

Mr. BENTIVOLIO. Okay. Now, according to my colleague, he said all we would have as far as taxes—we would eliminate gas tax, we would eliminate income tax, inheritance tax, all these other taxes—we would eliminate if we had a VAT. Is that right?

Mr. MARRON. Obviously, sir, it depends what the VAT rate is, but most of the scenarios I have seen would have the VAT and the income tax continue in some form. You would continue to need multiple tax streams most likely.

Mr. BENTIVOLIO. Okay.

Mr. MARRON. Except, unless we have a very, very large VAT.

Mr. BENTIVOLIO. Okay. I think that is where I am going to stop and yield back. Thank you.

Chairman GRAVES. Ms. Hahn?

Ms. HAHN. Thank you, Mr. Chairman.

Mr. Marron, I am glad we are having this hearing today. I think we can all agree that the tax code is excessively complicated. Small businesses with profits just high enough to keep them above water should not be spending thousands of dollars and hundreds of hours wading through a sea of paperwork. But a lot of the complications that we are talking about come from tax incentives aimed at incentivizing or assisting small businesses.

So Dr. Marron, are there ways that we can simplify the tax code for small businesses that encourage tax compliance but do not eliminate the advantages that small businesses have built into the tax code?

Mr. MARRON. Certainly. So I would like to second the call for expanding firms' ability to use cash accounting; that if you have a relatively small business that does not have any reason to do fancy financial accounting because they do not have outside shareholders or whatnot, there is no reason to force them to think about the world a different way from the one in which they run their business, and cash accounting can let them just have simpler things, run it out of their bank account, fits much more naturally into the way they run their businesses and could eliminate a lot of the compliance issues that we face.

Ms. HAHN. Thank you.

Anybody else want to comment on that idea?

Mr. KAUTTER. Well, I would, Congresswoman.

I think one of the problems, having worked at one point in my career on Capitol Hill, one of the problems is when legislation is drafted, simplicity is never considered. Right? The whole goal is to just draft the provision the way the members want it, and nobody says is there a simpler way to do that? Similarly, when the IRS gets a hold of the project, their goal is to weave a net that is so finely knit that not one person could get through it. And it is like a fisherman who weaves their nets so tightly that when they push the boat out from shore the boat sinks. So I honestly believe you could get to the same point or close to the same point with a lot less complexity.

And over the years I have done a number of studies in different parts of the code, and you can get 95 percent of the way there with

probably 5 percent of the complexity. It is that last 5 percent that really creates the mind-numbing complexity that we see.

Ms. HAHN. Yes, Mr. Reynolds?

Mr. REYNOLDS. I guess what I would add, our survey, one of the things that showed up in our survey is that small businesses ranked the cost of compliance to the code as their number one issue with the tax code. Number two was the financial burden associated with the code. And I think what that clearly says is that simplicity is really the objective here.

Ms. HAHN. I am going to follow up with you, Mr. Reynolds.

The Harbor Maintenance Tax is something that we collect at our nation's ports, and the point of it is it is to go back into keeping our ports and harbors maintained. And we have not done as good a job back here in Congress of actually appropriating that money for the purpose for which it was collected, which is one of my big fights back here. And I hope to one day convince my colleagues that we ought to be spending that tax for the purpose for which it was created, and in turn, that would be an investment in our infrastructure and the shipping companies that pay that tax would appreciate that because that means a lot to them that these ports are maintained and dredged so that they can come in and out of there efficiently.

Consequently, have you ever found in your survey or anything there would be any better feeling about paying taxes for small businesses if they felt like some of the tax was going back to help promote the small business economy?

Mr. REYNOLDS. I can only speak anecdotally. I do not think we have survey data on that, but I come from roughly the city of Cleveland, and I am very familiar with the Port Authority of Cleveland. That is a very important economic development organization within northeastern Ohio, and I think that from a small business perspective and an economic development perspective, there is no question that that would be a very positive thing if the money that was collected for the benefit of that port was able to be deployed by that port.

Ms. HAHN. Right. But do you think small businesses would appreciate or would feel better about taxes——

Mr. REYNOLDS. Certainly. Yeah.

Ms. HAHN.—if we devised a way to redirect some of those revenues to actually creating a better environment and economy for small business?

Mr. REYNOLDS. It is always good to see the results of your contributions.

Ms. HAHN. Yeah. Okay. Thank you.

I yield back.

Chairman GRAVES. Mr. Schweikert?

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

I have picked up bits and pieces as we have gone around, so I would actually like to go take one gigantic step backwards to sort of where the basis of the hearing was hopefully heading.

What do you consider to be the optimal tax system for what you and I would define as a small business? And within that, I would like you to state the—share with me is it cash accounting? Is it cash accounting with the caps that are in sort of the Ways and

Means proposal in regards to 179? What would be the optimal tax system to maximize efficiency, maximize compliance but also maximize small businesses doing what they are supposed to do, which is business?

Mr. KAUTTER. Well, Congressman, what I would propose is what I call a simplified cash method of accounting. And when I say that, what I mean is inventory would be immediately deductible. Assets, capital assets purchased would be immediately deductible. Wages paid would be immediately deductible. You would not have to worry about the inventory rules, the depreciation rules. A lot of the complexity in the Internal Revenue——

Mr. SCHWEIKERT. But is that not almost just classic cash accounting?

Mr. KAUTTER. It is exactly right.

Mr. SCHWEIKERT. In the Camp proposal, is it not cash accounting, is it up to——

Mr. KAUTTER. Ten million dollars.

Mr. SCHWEIKERT. Ten million?

Mr. KAUTTER. But what Congressman Camp does is while he raises the limit from five to 10, he makes no other changes in the cash method of accounting.

So, for example, if you are a small business and you have inventory, you have got to use accrual. And so——

Mr. SCHWEIKERT. So you would make sure the cash accounting was for all categories?

Mr. KAUTTER. It was real cash.

Mr. SCHWEIKERT. Okay.

Mr. Reynolds?

Mr. REYNOLDS. Well, first, I guess what I would like to tell you is our position with respect to Camp's work, we are very appreciative at how inclusive he has been and how much input he has taken from all quarters in putting it together. We think it is a good start.

In our written submission, you will see the NSBA has developed a set of nine principles around what we think an optimum tax system should be. I do not have a specific position on cash accounting.

Mr. SCHWEIKERT. How about something like the 179 caps?

Mr. REYNOLDS. Our biggest issue with 179 is the unpredictability of it and how it has been expired and——

Mr. SCHWEIKERT. Okay. But if it was permanent, you are comfortable though with the capital purchases of, what, 250,000?

Mr. REYNOLDS. Yeah, I am comfortable with it.

Mr. SCHWEIKERT. Okay, please. Yes, please.

Mr. ENDRES. The SBA tells us we have something like, in their definition, 27 million small businesses. And I think of all those owners when they set foot into the business world, they had lots of dreams of what they wanted to accomplish—their business, their expertise, whatever they are leveraging off of. But having a head for accounting and these rules probably was the last thing they considered. And so the simplicity really cannot be overstated because you either make a real study of this and commit immense amount of resources or you just, as we have done, is just opt out to go right down the middle of the road, take advantage of virtually none of these things for fear of raising your spectra of compliance

issues later, and you miss out on some opportunities but you can focus more on the business. So the simplicity and real world impact on companies cannot be overstated. I do not know what the measure or how you run it through a filter of real world considerations when legislation is proposed, but it has immense impact and has to be carefully considered.

And then sunsetting a number of these rules that stack on top of rules and stack on top of rules, I do not know how you do that because it there is just never enough time or energy to do it.

Mr. SCHWEIKERT. Okay. So those are the externalities even outside the tax system, now it is the enhanced regulatory system?

Mr. ENDRES. It is described when the IRS gets involved and puts in their layers and tries to build in their protections, it becomes unworkable. It is understandable why they would do it, but that is why when we try these set asides, these cutouts, the law of unintended consequences kicks in and ultimately is a negative, I believe, in the aggregate.

Mr. SCHWEIKERT. Okay.

Doctor?

Mr. MARRON. So the one thing I would add to that then is once we have this optimal small business tax system is to make it stable. Because if you think about it, for all these provisions, there is a learning curve in figuring out how to incorporate them in your business practices and your accounting practices and your tax paying practices, and that has an opportunity to become much more efficient and much less painful if it is the same rules from year to year. And if they change from every year it just adds significantly to the pain.

Mr. SCHWEIKERT. Okay. So sort of a tax stability, cash avoidance of accrual. Okay.

And Mr. Chairman, I will throw you one other that is a little more ethereal to talk about is designing a tax system that also looks at the very aggressive changes in sort of what a small business is in the economy and the peer-to-peer economy, and the use of technology. Many things are microbusinesses with high rates of turnover because technology allows them to do that. And my fear is some of the caps, like in the 179, others creates some interesting distortions and change sort of the design of the business you would actually create.

So with that, Mr. Chairman, thank you for your patience. I yield back.

Chairman GRAVES. Ms. Chu?

Ms. CHU. Yes, thank you, Mr. Chair.

Dr. Marron, I agree that our tax code is complicated for small businesses to navigate, and I saw this firsthand as a member of the Board of Equalization in California, our country's only elected tax board. And I saw many microbusinesses that were in trouble. Nine out of every 10 small businesses in this country is a microbusiness with five employees or less. And according to the U.S. Census, only one in three self-employed entrepreneurs earns more than $25,000 per year from their business.

Considering the fact that a tax reform bill could be some years away, I introduced the Entrepreneur Startup Growth Act to help ease the tax compliance burden on small businesses. It would es-

tablish a self-employment tax initiative grant program at the Internal Revenue Service in consultation with the Small Business Administration to provide individuals with affordable tax preparation and business development assistance. Local organizations, higher education institutions, and local governments could run programs locally.

What are you thoughts on this idea and other similar efforts to relieve the tax compliance burden on the microbusiness without having to reform our tax code?

Mr. MARRON. So there seems to be a lot of evidence from the taxpayer advocate and other folks that if you have a sincere person who wants to comply with the tax code and they reach out to the IRS to get assistance, they find it frustrating and unproductive, and often unsuccessful, and sometimes get the wrong answer. And that is on top of just the challenges of complying with the tax code once you know what it is. So I think we have identified a very important issue, which is can you do things to help people to understand exactly what their requirements are and the easiest way for them to comply with them, and we are nowhere near best practices at that at the moment.

Ms. CHU. I was thinking about the Small Business Development Centers. They are very valuable entities. Of course, one of the most effective programs of the Small Business Administration, and they allow small business owners to consult face-to-face with somebody who can help them with all kinds of assistance. What are your thoughts about using the SBDCs to provide tax preparation assistance to small business?

Mr. MARRON. I will confess that I do not have a lot of familiarity with them. My apologies.

Ms. CHU. Yes?

Mr. ENDRES. Let me speak to that briefly. I have found the SBDC in our area to be inordinately helpful. They have not only helped our company but other companies they have helped they have sent to us and we have been a resource, too. But I would not look to them for any tax support or help because ultimately, we have got to turn to the IRS. And many times we have an expression in our accounting circles when working that it is often dealing like with a snowflake at the IRS; you get a different answer every time.

We just went through an audit where they were looking at the issues of what is a contractor? And we had someone who worked for five other companies and was a contractor for those five, but it was a 1099 but still ruled that person to be an employee because we wrote our check directly; she did not bill us directly. That one out of the eight criteria the IRS decided that was still an employee. And yet, I could not get the SBDC to give me guidance. I should not look to them. It is hard enough for the IRS. And now with their overload, getting answers out of them or doing an amended return could take months to get it back. They are so overwhelmed. It is difficult to figure how we can do anything without just simplifying and making it simpler for everyone. Complexity is just ruining the process.

Ms. CHU. Well, let me ask for anybody on the panel, each of you expressed the need for broad tax reform, the Section 179, expensing

cash accounting and various recommendations for rate reduction. But since it may take time for that to occur, perhaps even years, what do you think would be the most important thing to do in the short term?

Mr. KAUTTER. Well, Congresswoman, I think the single, most important thing that can be done without broad tax reform is to simplify the cash method of accounting. There are too many businesses that get forced onto the accrual method.

And with respect to getting taxpayers' help, if I can go back to that for a second, I was with one of the big accounting firms, and I used to say at the end of the day that if the IRS audited every piece of advice we gave nationwide, we would be broke. But that assumes the IRS could figure out the answer as well. And they cannot. And so I think the real core, you have got to go back. Just do some things that would make it very simple for small business because the complexity in the Internal Revenue Code comes from trying to compute taxable income. And if you make that simple, you make a lot of progress.

Thank you.

Mr. REYNOLDS. I would say recognizing the possibility that the tax reform is on the horizon somewhere. The thing you can do most is not change much for a while, just to give us a period of stability and predictability so that we can adjust our businesses and be able to plan in advance would be a big help.

Ms. CHU. Okay. Thank you. I yield back.

Chairman GRAVES. Mr. Collins?

Mr. COLLINS. Thank you, Mr. Chairman.

Thank you all for coming. I agree. Fundamental tax reform is the one thing that I believe can get this economy moving again.

I own a number of small businesses, and just so you know, I do my own taxes. I have read the tax code. I know it inside out. My tax return was 69 pages. I have eight sub Ss and four LLCs in all types of industries. So I do know, and we will talk about cash accounting in a second.

First of all, the one thing that hits me when I do this is every dollar I send to the government is a dollar I cannot invest in my business. So those who say on the other side let us just tax corporations more—tax, tax, tax—every dollar I send to D.C. to be wasted is a dollar I do not reinvest in my business to grow and create jobs. That is the fundamental thing.

The other rhetorical comment I will make is it is insanity that we are taxes all my companies and small businesses at 39.6 percent, but it is more than 39.6 percent. I need to remind the folks on the other side. Under the tax code this year, I lost every exemption. I get no personal exemptions, no family exemptions, and because this income is flowing through my personal tax return, I lost 20 percent—no, 80 percent of my itemized deductions. With the complicated tax return I have of 69 pages, I took the standard deduction because I lost 80 percent of my itemized deductions. So my tax rate is not 39.6. It is 39.6 plus what happened with the loss of exemptions, every one, zero, and losing 80 percent of my itemized deductions. That is how crazy the tax code is and how it disincentivizes or penalizes us. We cannot invest in our business. So that is my rant.

But by doing my own taxes, a couple of questions. First of all, and I am assuming you all agree—you can give me a quick yes or no. It does not make sense to do sub S and LLCs at 39.6 and big corporations at 35. Do you agree?

Mr. MARRON. It is complicated.

Mr. COLLINS. I kind of asked for a yes or no.

Well, let me ask you a yes or no. Let me ask you. Are we not the only country in the United States—in the world without a VAT?

Mr. MARRON. Only significant country, yes.

Mr. COLLINS. In fact, the only three that are not are African countries that do not have a GDP? I mean, every developed country, every industrialized country has a VAT?

Mr. MARRON. Except us. Yes.

Mr. COLLINS. And if there was a country that could completely replace their taxes, income taxes with a VAT, would it not be the country where we are 4 percent of the world's population and 25 percent of the world's GDP? Is it not the one scenario where it could work? Four in 25.

Mr. MARRON. So I have not seen a VAT proposal that would do that.

Mr. COLLINS. But would you not agree we are the one country that could at four and 25? You cannot do it—if you are 2 percent of the world's population and 1 percent of the world's GDP—if you are China you could never do something like that. Four in 25, that math is staggering, which makes you wonder how it is we are not churning money left and right. Maybe you do not like yes or nos. But anyhow, let us move on.

Mr. MARRON. The curse of being in think tanks.

Mr. COLLINS. The deductibility, one thing I have noticed is you cannot offset passive losses unless you have passive income. And a lot of companies generate what you could call passive losses or R&D tax credits, and an investor and owner cannot take credit. Would you suggest eliminating that requirement? That is something simple we could do to say the requirement that you have to have passive income to offset passive losses? It makes no sense to me.

Mr. KAUTTER. It is something simple that could be done. In fact, it was put in the law in 1986 to raise revenue. At the time it was enacted, it really departed from the concept of tax expenditures because it says we understand you have got a loss; we are just not going to let you claim it.

Mr. COLLINS. And if you cannot claim it, then you are paying higher taxes and you cannot reinvest the money in your business?

Mr. KAUTTER. And you have got a loss. You have got a real loss.

Mr. COLLINS. That is right. And you cannot use it.

Mr. KAUTTER. Yeah.

Mr. COLLINS. All right. So cash accounting. Be careful. I mean, because here is the nuance there. If I am a small business and I use cash accounting and I write off my equipment, if I write off my inventory and I have got a contract that is going to cross the year, so I just had a huge write-off because the inventory is in my shop. I am not going to bill it until next year. I am not going to get paid

until next year. And I have a huge loss. And there are restrictions on how—so I have no income. So if I have no income, I do not take advantage of any of the marginal brackets. None of them.

So now I go to the next year. I ship this thing out. I make all this money. And again, depending on how your carry-forwards work, you could find yourself you lost those marginal brackets forever. Now you go into 39–6. You lose all your exemptions. You lose 80 percent of your deductions. I could see where cash accounting would not be good.

Mr. KAUTTER. And I think, Congressman, what you are describing is why you would not want to manipulate your income particularly from one year to another.

Mr. COLLINS. It is not manipulating to have a big contract.

Mr. KAUTTER. I understand that. But if you want to take advantage of the brackets, you would have to make sure that you did not spend every year trying to zero out your income. And that is what people get concerned about in the cash method is somebody at the end of the year——

Mr. COLLINS. You cannot change when your customer needs the product, and if you are shipping it in January and you are building it in December, I mean, that is not manipulation. That is just called it takes me two months to build it so my inventory cost is in December, my revenue is in January. That person loses all the benefit of their marginal brackets.

Mr. KAUTTER. They do.

Mr. COLLINS. Thank you, guys. I could go on and on, by the way.

Mr. KAUTTER. I am impressed. And you are forcing me to reconsider my line. Since 81 percent of small businesses tend to hire tax preparers, another 10 percent use both software and a tax preparer, the other 9 percent of the returns are completely wrong. So I have got to amend that now that you are doing your own return.

Mr. COLLINS. And I do not use software either.

Mr. KAUTTER. I am impressed.

Chairman GRAVES. Mr. Schrader?

Mr. SCHRADER. Thank you, Mr. Chairman.

I am proud I do not do my own tax returns. I have better things to do.

I guess a question generally. I do not know if it is possible for you to answer, but the discussion on the value-added tax is interesting. The comments by my colleagues I think are on point. So what would be the rate that you would have to have for a VAT to completely replace all business taxes, both corporate and sub S, LLC, partnerships, all that? What would that rate have to be?

Mr. Marron, do you have any clue?

Mr. MARRON. I hesitate to make up a number on the fly, but I suspect it would be a two-digit number beginning with a one.

Mr. SCHRADER. Okay. Mr. Endres?

Mr. ENDRES. Well, one of the points of the VAT tax is not what it is, what it is going to become because it is hidden and moves below public awareness many times. But what I do like about anything that is somewhat consumption based is this vast underground economy that pays zero taxes. And when you consume and you buy whatever you buy, you are paying in. It has got to have

some unbelievable effect of broadening the tax base to get the consumption. But the slippery slope of VAT taxation, I understand the arguments against it, but there has got to be something. In our life, in our business, I just see if you are a business, you either have to play by the rules or you do not at all. Just consumers or business, there are wonderful ways of just living under the radar and paying nothing. And it is a travesty. It is a very expensive one.

Mr. SCHRADER. To your point, the Oregon Department of Revenue, when I was in the state legislature, did some work and was able to model with some sort of consumption tax, how much revenue reducing income tax is dramatic, corporate included, capital gains, how much money they were able to gain from that underground economy. It was pretty staggering actually to your point.

Second, a follow up then would be what business types would object to that? It would not matter if everyone was treated the same, I assume. So what businesses, however, might object because they end up paying a little bit more under VAT than their current forms? What businesses would object to that, particularly small businesses?

Mr. Kautter?

Mr. KAUTTER. Well, the thought that comes across my mind is it would depend on the amount of effort to comply. If the forms were relatively straightforward then I think most small businesses could handle it. But if it got complicated they would not.

The other point I would make on the value-added tax, and I am sure Mr. Marron is more knowledgeable about this than me, but I think many countries that have implemented a value-added tax still maintain an income tax. And so——

Mr. SCHRADER. Well, I was talking with regard to businesses.

Mr. KAUTTER. I know.

Mr. SCHRADER. These businesses, to simplify that, make it straightforward, avoid the underground economy, everyone pay their fair share, if you will ostensibly. I just did not know. We pick winners and losers all the time here with different tax credits, deductions and stuff, and we are probably not the smartest group in the world to pick winners and losers, so it would be smart I think just to simplify things. And that is one.

The other way to go about it is look at a set rate. Say you got rid of all the deductions. Say you got rid of every single deduction, tax credit. I know sometimes it is tough to tell if it is a deduction or a change in whatever practices. Say you got rid of all that. Is there an appetite in the small business world, big business world for that matter, business world in general or a set tax rate for all business income and avoid all this deduction, save a ton of money in compliance. Simplicity would be the name of the day. What would that rate end up being?

Mr. Reynolds?

Mr. REYNOLDS. I would say that there is some appetite for it. Our organization supports, for example, what is referred to as a fair tax, which is essentially that, a flat rate. Very simple.

Mr. ENDRES. It has also become evident to me in my years in business that businesses really do not pay taxes. You know, it is all paid through the consumer and it is just passed on. It is an interesting discussion but we really do not. It is a flat deal. It affects

everybody equally. It is a little more fair than those who can play the tax system better, put more energy into that as opposed to growing the economy and growing jobs. Fair, simple. What is not to like?

Mr. SCHRADER. Mr. Marron?

Mr. MARRON. So a lot of folks have taken a crack at writing down tax reforms like that. So Bowles-Simpson, Domenici-Rivlin, other folks. In a room of well-meaning people who are not constrained by the political process too much, it looks like you can write down plans where you get down to about a 28 or 27 percent rate across both corporate income and individual income which then applies to pass-throughs. As we saw from Chairman Camp's effort that if you try to do it in a way that faces more political constraints, you start ending up with rates that begin with threes and that have some of the preferences maintained.

Mr. SCHRADER. Very helpful. Thank you, gentlemen. I yield back.

Chairman GRAVES. Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Collins, well done. I am impressed. I was in the banking business for about 35 years. I did our bank's taxes myself for about 25 years and I finally got to the point that this is not going to work very much longer. But just so you do not fulfill the old adage about the lawyer who has himself for a client.

Gentlemen, thank you for being here today. Yesterday I had in my office a gentleman who has a string of Taco Bells, I think 25 of them as a matter of fact, and he was talking about the definition of full-time employee and how that is impacting his business from the standpoint of what goes on with the Affordable Healthcare Act and how he manages the rest of his employees and other things. And of course, the Affordable Healthcare Act has been deemed a tax by the Supreme Court in their enlightened wisdom. And so I was just kind of curious as to your thoughts about that, the impact of the tax implications that you see, positive, minus. I know it was something that was top of mind to this gentleman.

Mr. Reynolds, I know you are a small business guy. What would be your comments?

Mr. REYNOLDS. Speaking just from my own small business, I have 38 full-time employees. We are in the software business, and that, for us, has not been a specific issue associated with it. It does have significant impacts speaking from an SBA's perspective. It has very significant impact particularly on businesses that are in retail and food service which are perhaps not the majority but a very large segment of small business. And to have to be forced to rearrange your workforce in order to deal with that is suboptimizing the business and hurting the economy.

Mr. LUETKEMEYER. One of his concerns was he had a group of employees that were in the management area and then he had another group that was in basically the 28 to 34 hour per week range that were very important to him. They were the supervisors. They were the shift supervisors, the folk who made sure the rest of the folk did their job. They were the ones who were teaching the ones who were in the 12 to 25 hour range, and it was very important. And now this group of people he relies on to actually manage

his operations so to speak of his business were going to have to be tinkered with their hours and it is really made a hardship on him.

Any of you other folks on the panel have a comment with regards to that?

Mr. ENDRES. Over the last 15 years, we have paid 100 percent of our employees' health insurance and probably had too many bells and whistles going back to the dot-com era. But we have our insurance firm, just through having to—just the way things are structured and being able to—they have explained to us that they have had to raise our rates 40 percent just because of the fact of the other obligations they have to now hit. That hits us where we have to start scaling back what we were once doing at 100 percent and dropping off many of the dental, the vision, all the things that we had before. We are not big enough to be hit, and we do not have the part-time labor issues, but that was one practical impact on our company.

Mr. KAUTTER. And I would say Mr. Endres's comments are similar to comments we are getting at the Tax Center. Small businesses, many of whom had traditionally paid 100 percent of the healthcare costs are dropping the programs. They are going to raise the compensation, which will be taxable to the employees, send the employees to the Exchange, and just get out of the business of providing healthcare. It has gotten too expensive and too complicated, even though technically the Affordable Care Act does not apply to employers with under 50 employees.

Mr. LUETKEMEYER. Another quick question for you. It is kind of interesting. The SBA has a definition of small business as anybody 499, basically less than 500 employees, yet the healthcare law, their definition is under 50. Where do you see this playing out? Is this a problem? There is no consistency here. Anybody have any comments on that?

Mr. REYNOLDS. There are dozens of definitions of small business sprinkled throughout the law, not only the Affordable Care Act but the law in general. For NSBA, I would say that while that is our definition, in terms of our membership, well over 90 percent I think are under 50 employees.

Mr. LUETKEMEYER. Would you support something, for instance, that changed to the healthcare law that would raise it to 500 so that it would be consistent with everything else?

Mr. REYNOLDS. I am not sure I can answer that knowledgably at this point.

Mr. LUETKEMEYER. Okay.

Mr. REYNOLDS. But I can certainly get back to you on it.

Mr. LUETKEMEYER. I see my time is expired. I will yield back. Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Schneider?

Mr. SCHNEIDER. Thank you, Mr. Chairman. And thank you to the witnesses for being here.

Professor Kautter, like you, I started my career at PriceWaterhouse, not Ernst & Young, but I started on the consulting side. And after 30 years, or almost 30 years of working with clients, I understand one thing in business in strategy or in operations, complexity has associated costs. And I think it is the complexity of the tax code that leads us to an urgent need for com-

prehensive tax reform. But within that, I introduce a resolution, a bipartisan resolution calling for Congress, the House of Representatives, to make sure that we deal with both corporate and individual. Because 90 percent of our operating entities are these pass-through entities.

If, however, Congress chooses to focus strictly on the corporate side and lower the rates in such a way to get to the point as the Camp proposal does of eliminating so many of the tax expenditures—so-called expenditures—and small companies have to move from their old structure, LLC, S corp, whatever, to a C corp, what is going to be the cost on those companies to do that?

Mr. KAUTTER. Well, I think the restricting cost would be substantial and frankly, very frustrating.

But, you know, Congressman, the proposal I talked about a little bit earlier of a single business tax rate schedule is designed to deal with this issue. In other words, if all you wanted to do was reform business taxes, right, and you did not want to worry about the mortgage interest deduction and state and local tax deductions and the phase-out of the personal exemptions, change the rules for all businesses with respect to depreciation, inventory, whatever you want, and then apply a single business rate schedule. So a sole proprietor would pull out of their individual return their Schedule C and subject that to tax at the business rate schedule, not at the individual rates. And that way you could get corporate business reform. Change all the business tax rules and tax all businesses at the same rate without having to work your way through the complexity and the difficulty of dealing with all the individual changes.

Mr. SCHNEIDER. Any others?

Dr. Marron, do you have thoughts on this issue?

Mr. MARRON. I view it as politically unlikely because the bumper sticker will be so terrible of reducing taxes on multinationals and raising them on small businesses. But hypothetically, what you describe, which is that you would have higher tax burden on the pass-through entities. Some of them would choose to bear that and remain in the system as it is, and then some would bear the change cost as just described.

Mr. SCHNEIDER. Mr. Endres, I will turn to you for a second. You talked about making the choice to stay below 30 employees because of the complexity of the tax code. If we had a more simple system that allowed you to grow your business, how big would you have grown? What would have been the impact over your business?

Mr. ENDRES. Well, it is difficult to say that. It is more because of the uncertainty of the tax code and what the next rule is going to be and the next threshold. We have got limitations on the definition of a small business that sometimes it is 11 people, sometimes it is 22 or 30, 50. And so you never quite know what the rules will be. It is safest to stay around 30 and then outsource the rest, leverage off of other resources. Just be less people-intensive. And it is unfortunate because it has a real impact on hiring. And I think a lot of our tax law has built a huge offshore industry of offshoring a lot of jobs because of this concern. We do not have to use people in this country anymore with all the uncertainties and vagaries of how they are taxed.

Mr. SCHNEIDER. I am sorry; I am going to take back my time because we only have a minute.

It is not just complexity, and Dr. Marron, you touched on this, it is certainty. It is the sense of every year it is going to change. If we could have certainty, let us say a five year confidence level of what the 179 deduction might be or what the R&D credit might or might not be, what impact would that have on our economy and the ability of small businesses to start making decisions, long-term decisions and investing in people or equipment and the things that will drive the economy?

Mr. MARRON. If you think about those provisions, they do two things. One is they reward firms for undertaking those activities that we think are beneficial. And the other thing it does is actually provide like a carrot to think about, hey, you are going to get a reward if you do this. And they actually act as an incentive. And we are in this unfortunate world where there is uncertainty and they expire and whatnot that we are missing a chunk of the incentive effect. And it is sort of like an after-the-fact sweetener rather than something that firms can be confident will be there.

But if we can go to your scenario, if we know it is in place for five years, then firms can put together investment plans and R&E plans over five years, recognizing that, putting it in their spreadsheets, and having it as an incentive for them to do more of it.

Mr. SCHNEIDER. I see I am out of time. My closing remark on that point is oftentimes if Congress waits until December, it is rewarding people for making decisions they would have made otherwise and not providing the incentive. So I think the importance to have it laid out is critical.

Mr. REYNOLDS. Or in this case, April or May.

Mr. SCHNEIDER. Right. With that, I yield back. Thank you.

Chairman GRAVES. Mr. Payne?

Mr. PAYNE. Thank you, Mr. Chairman.

Mr. Endres, looking through your testimony, you mention that the deadline for the corporate tax returns should be extended beyond the current cutoff date of March 15 to add a few more additional months. Can you be a little more specific in terms of the timeframe you feel it would take to produce a quality corporate return?

Mr. ENDRES. Well, our tax and financial data comes pouring in through January and into early February. We have a March 15th filing deadline. Our accountant needs three weeks to prepare the return. He has got a crush of every one of his clients have to be done all at the same time in three weeks. That gives us a window of about two weeks to work on it and get it cleaned up for our accountant. And so our business pretty much just stops while we attend to it. There are some years we have just skipped over and just let it fly and if we missed opportunities to deduct and we missed things, so be it. We are just too busy. We pay the taxes as they are due, but if we had several more months, I do not know, September 15th, taxes would still be paid on time but we would have the time to do a much higher quality return, working closer with our accountant when he has time to review the prior year's fiscal data and do a better return.

Mr. PAYNE. Anyone else like to take a stab at that?

Mr. KAUTTER. I do not know the statistics, Congressman, but there is a very high percentage of businesses that are not as diligent as Mr. Endres, and the automatic reaction is to file an extension. The problem with filing an extension is you have to pay your taxes or you pay penalties. So you pretty much have to have a good idea of what the tax liability is. So I would think if you could push the due date out another month to two months you would probably have something that is much more reasonable.

Mr. PAYNE. Okay. Thank you.

Thank you, Mr. Chair. I yield back.

Chairman GRAVES. Well, I want to thank all of our witnesses for being here today. Taxes have a profound effect on the operation of small businesses. Tax provisions very often drive the decision-making process when it comes to businesses purchasing, expansion, hiring, whatever the case may be. We are going to stay very engaged in this, the Small Business Committee is. It is an important issue to all members on the Committee.

Again, I want to say thank you for coming out, some of you coming so far to be a part of this hearing.

I would ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record.

Without objection, that is so ordered.

The hearing is adjourned.

[Whereupon, at 2:21 p.m., the Committee was adjourned.]

APPENDIX

Testimony of
Professor David J. Kautter
Managing Director of Kogod Tax Center
American University Kogod School of Business
Washington, District of Columbia

Committee on Small Business
United States House of Representatives

Hearing on
The Biggest Tax Problems of Small Businesses
April 9, 2014

Chairman Graves, Ranking Member Velazquez and Members of the Committee, thank you for the opportunity to testify on The Biggest Tax Problems of Small Businesses.

My name is David Kautter and I am the Managing Director of the Kogod Tax Center. The Kogod Tax Center is an independent tax research institute located at American University's Kogod School of Business. The Kogod Tax Center promotes balanced, nonpartisan research on tax matters affecting small businesses, entrepreneurs and middle-income taxpayers, including the challenges of complying with the Internal Revenue Code. We also develop and analyze potential solutions to tax-related problems faced by these three groups of taxpayers and promote public dialogue about critical tax issues.

I have been a tax practitioner for over 40 years. Prior to joining the Kogod Tax Center, I was the Director of National Tax for Ernst & Young. Over the course of my career as a tax practitioner, I have witnessed, with much disappointment, the tax law grow increasingly complex in its structure, pervasive in its reach and incomprehensible in its nature. There is little doubt that the nearly paralyzing complexity, overwhelming length and constantly changing nature of our federal tax laws are having a profound effect on small businesses, affecting not only their decision making but impeding their ability to grow and create jobs.

The National Taxpayer Advocate has found that the single most pressing problem encountered by taxpayers, including small businesses, is the complexity of the Internal Revenue Code. The National Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours complying with tax filing requirements, the equivalent of 1.25 million full-time jobs. According to the National Taxpayer Advocate, more than 70% of all unincorporated businesses (which tend to be small businesses) use paid tax return preparers

and spend more than $16 billion for professional advice and compliance assistance from attorneys, accountants and enrolled agents. While this complexity has generated a healthy business for tax professionals, our economy suffers as a result, for it cannot prosper when small businesses are diverting disproportionate time and resources to activities that neither grow their businesses nor create jobs. The tax complexity that small businesses have to endure is an inevitable drag on the economy.

It is estimated that the Internal Revenue Code is nearly four million words in length, and the income tax regulations are in excess of another 5 million words. Overall, taxpayers – businesses and individuals – are estimated to spend more than 6.1 billion hours meeting their annual federal tax filing obligations, and it is estimated that 60% of all taxpayers retain paid tax return preparers to fulfill their federal tax filing obligations while another 30% use commercial software. I can personally attest that the effort required to comply with the tax law today is disheartening even to experienced tax professionals. The cost to comply is increasingly expensive in time and dollars. Not only is it increasingly expensive in terms of time and dollars to comply with the tax law, the tax law is increasingly distorting individual and business decision-making, especially that of small businesses. In my experience, most tax professionals would prefer to spend their time advising clients on the tax consequences of growing their businesses, not on complex compliance activities that add no value to the business.

Sources Of The Biggest Problems Facing Small Businesses

The Kogod Tax Center conducts periodic surveys of small business tax return preparers and tax advisers, most of whom are also small business owners themselves. Based in large part on surveys we have conducted over the past three years, as well as discussions we have had with small business owners and their tax advisers, and personal experience, my view is that the biggest tax problems facing small businesses come from two sources: complexity and constant change in the tax law. As a result of complexity and constant change, here are what I believe to be the seven biggest tax problems facing small businesses.

Understanding The Law And Compliance Obligations

Most small business owners simply have very little idea of what is expected of them under the tax law and have given up trying to understand either the substantive provisions of the tax law or their compliance obligations. They increasingly rely on outside tax advisers for tax planning and tax return preparation for both income taxes and employment taxes. They worry about making a mistake that will cost them time, money and their reputation because they unknowingly made a mistake, so they have "outsourced" their tax planning and tax compliance obligations.

This is most clearly seen in the number of small businesses that have their income tax return prepared by someone else. Similar to the findings of the National Taxpayer Advocate, a recent survey conducted by the

National Federation of Independent Business (NFIB) found that professional tax return preparers either completely or partially prepared tax returns for 91% of its members – 81% had them prepared exclusively by a professional, and another 10% used both a software package and a professional. Given the complexity of the tax law, that means to me that the other 9% are, most likely, completely wrong.

When citizens and business owners do not understand their obligations under the law, resentment, suspicion and skepticism follow. When resources and time have to be diverted from running a business to gathering information so a tax return preparer can prepare a form that the business owner does not understand and has to sign under penalties of perjury, there is an understandable sense of fear, intimidation and frustration.

This sense of skepticism, trepidation and frustration can clearly be seen in a 2012 survey of over 3,300 sole proprietors conducted by the Taxpayer Advocate. The survey found that only 16% of the sole proprietors surveyed said they believe the tax laws are fair and only 12% said they believe taxpayers pay their fair share of taxes. The results of these surveys mirror my own personal experience in dealing with small business owners. From a public policy or business point of view, this is not a healthy state of affairs for a democracy that bases its tax compliance system on self reporting.

Constantly Changing Law And Regulations

It has been estimated that since 2001, there have been almost 5,000 changes to the Internal Revenue Code, an average of about one a day. While most small businesses have outsourced their tax planning and compliance, the tax professionals they hire have to keep up to date with all the changes in the law and accompanying regulations. This cost is passed along to small businesses in the form of higher tax consulting and return preparation fees, contributing to a further drain on the resources from small businesses.

Another major issue for many small businesses created by the constantly changing nature of the tax law grows out of the so-called "tax extenders". Fifty five tax provisions expired in 2013 and another six are slated to expire this year. While that is a large number, only a handful directly affect small businesses. The special rules for qualified small business stock (Section 1202 stock), the rules relating to depreciation of qualified leasehold improvements and restaurant buildings and improvement, bonus depreciation, and the S corporation built-in gains tax, all matter to various members of the small business community. But, far and away, the most important "tax extender" is the ability to immediately expense depreciable property (Section 179). In fact, for many small businesses it is the **only** one they really care about. Small businesses are frustrated with their inability to know what the rules for expensing and depreciating equipment will be from one year to the next, and sometimes (like this year) what the rules will be for the current year. Small businesses often end up making decisions on whether or not to purchase equipment before the rules are settled. Not only does this have an effect on small businesses themselves, it has an effect on the overall economy. The constant changing of the expensing rules makes informed planning for capital purchases impossible and leads to decisions being made by small business owners without full knowledge of the economic consequences of their decisions. This is not the way to

encourage growth in our economy overall and especially for the sector of our economy that provides over half of all jobs and most of the new jobs in the country. These rules need to be settled.

Constantly Changing Filing Requirements

One consequence of the constantly changing law and regulations is constantly changing filing requirements. Every year, the IRS seems to expand the information required on income tax returns and the Form W-2. Although preparing tax returns (both income tax and employment tax) has largely been outsourced to tax return preparers, small businesses still have to provide the necessary information to their tax return preparers and that is a source of frustration both in terms of time and cost. Since the tax law and regulations are constantly changing, the information required to comply with the tax law is also constantly changing which means the forms are constantly changing which, in turn, means the information required from small businesses is constantly changing. For example, here are the changes made to two of the most often used tax forms for small businesses over the past three years.

Changes To Schedule C

2011

New lines "i" and "j" were added to Schedule C, which address the required filing of Form 1099.

Changes were made to "Part I – Income" for new "Merchant card and third party payments reporting requirements". Line "1a" and "1b" were added to implement reporting of gross receipts received via merchant card and third party network payments. Line "1c" was added to report income reported on Form W-2 if "Statutory Employee" box on that form was checked.

Qualified joint ventures reporting rental real estate income that is not subject to self-employment tax had to report that income on Schedule E instead of Schedule C.

2012

The changes that had been made to Part I for separate payment card reporting in 2011 were reversed, and the gross receipts received via payment card and third party network payments are no longer reported separately on Schedule C.

2013

A "Simplified method" for business use of home deduction is added to Line 30 of Schedule C.

Changes To Form 1065

2011

- "Schedule A" (Cost of Goods Sold) was deleted from Form 1065.

- On Schedule B, line "3a", "any foreign government" was added to the list of partners the partnership may need to disclose.
- On Schedule B, new lines "18a" and "18b" regarding Form 1099 were added.
- On Schedule B, new line "19" for Form 5471 was added.
- On Schedule L, line "7a" (Loans to partners or persons related to partners) and line "19a" (Loans from partners or persons related to partners) were added.

2012

- On Schedule B, line 20 (number of partners that are foreign governments under §892) was added.

While none of these changes by themselves are a major re-working of the forms, each takes time for small business owners and their advisers to understand and implement. Having to dig through their books and records to assemble new information takes time away from running a business. It is not only the business owners who are frustrated. In the Kogod Tax Center's most recent survey, the factor cited more than any other as contributing most to decreased efficiency (and increased cost) was new IRS and state regulations and other filing requirements. This factor was cited by 46% of our tax return preparer respondents. In the same survey, 81% percent of the tax return preparers cited the time and complexity of gathering data to complete returns as the most frequent complaint heard from their clients during the 2013 filing season. This was up substantially from our 2012 survey on this same issue where just over half (56%) of the tax return preparer respondents said the biggest concern for their clients was the time and complexity required to compile data for return preparation. Significantly, this factor contributes to the inability to complete tax returns by the original return due date, thereby necessitating extensions and turning the tax compliance process into a year-long, never ending cycle for small businesses.

Steadily Increasing Federal Complexity

It would be one thing if the effect of the constantly changing law and filing requirements was to make things simpler, but for most small businesses it is the opposite. Complying with the tax law is becoming more and more complicated and burdensome. Recordkeeping, compliance and reporting are diverting more and more time and money away from operating and growing their business.

By any measure, tax returns for small businesses are becoming more complex, difficult as that may be to fathom. This is undoubtedly the result of the increasing complexity of the tax law and regulations. As the tax code has been amended and "patched" since the 1986 tax reform proposal, it is becoming increasingly unwieldy even for the most experienced tax professional, let alone small business owners themselves.

More than 50% of tax return preparers who responded to Kogod Tax Center's most recent survey said that Form 1065, "U.S. Return of Partnership Income," is the most complex return to complete. Some of this is presumably due to the rising complexity of how partnerships are structured for both business and tax reasons, but undoubtedly a large part of it is the underlying complexity of the law and regulations. Form 1040, "U.S. Individual Income Tax Return," was cited by about 20% of tax return preparers as the most difficult to prepare, and 16% cited the Form 1120, "U.S. Corporation Income Tax Return," for C corporations. The good news is that only 14% cited the Form 1120S, "U.S. Corporation Income Tax Return" for S corporations as the most difficult. It is time to simplify the law and the filing requirements. It is a sad commentary when tax return preparers view the returns they have to file for small businesses conducting business as partnerships (Form 1065) and sole proprietors (Form 1040 Schedule C) as more complicated than those they have to file for their much larger corporate clients (Form 1120).

Controlling The Internal And External Cost Of Compliance

With increasing complexity of the law and compliance obligations, small businesses are increasingly worried about scarce resources being diverted from their business. Increased complexity translates into higher fees for outside tax advisers and more internal time devoted to non-revenue generating tax compliance activities by small businesses, themselves.

As I mentioned earlier, in a Kogod Tax Center survey conducted last year after the close of the tax filing season, in a virtual chorus of unanimity, 81% of tax return preparers cited the time and complexity of gathering data to complete returns as the most frequent complaint heard from their clients. This was up substantially from the 56% that cited that as the main complaint from clients the year before. In the same survey, 40% of the tax return preparer respondents said they spent either moderately more or significantly more time preparing returns than they did the year before. Some of the reasons cited were the increased complexity of the returns themselves and complexity related to information reporting, partnership allocations and basis reporting. Not surprisingly, more than 70% of tax return preparers said their fees had increased from 2012. While this is good news for tax preparers, it is not such good news for small businesses.

In a recent NFIB survey, small business owners were asked what part of the Code is the most complex or complicated for them and their business. The majority (52%) reported that they let their tax professional worry about complexity, and they will pay for the help they need. They feel as though they have no choice. Relying on tax advisers and return preparers to this extent is the wise thing for most small business owners to do given the complexity of the tax law, the time involved and the penalties imposed when a mistake is made. However, it also makes it hard to control both the cost of tax planning and, especially, the cost of tax compliance. This is not a healthy state of affairs.

Dealing With The IRS Takes More Time

The increasingly complex and constantly changing tax law is also affecting the ability of the IRS to respond to small business inquiries and settle disputes. Many small businesses and their tax advisers complain that their ability to get questions answered by the IRS and solve problems is taking more and more time. They cite several reasons ranging from a decline in the knowledge of IRS personnel with respect to particular areas of the tax law, to the inability of agents to resolve matters on their own without escalation to supervisor(s). When ranking IRS performance, our surveys show that most small businesses and their advisers believe IRS service has gotten worse in every category we surveyed over the past 5 years. Ranked from greatest to least areas of decline in service are: (1) ability to resolve controversies in a timely manner, (2) timeliness of IRS response to inquiries, (3) performance of IRS personnel, (4) knowledge of IRS personnel, (5) ability to resolve controversies without escalation to a supervisor(s) and (6) clarity of IRS correspondence.

Specific Areas Of Complexity

One area where our surveys have shown consistency over the past three years are the specific substantive provisions of the tax law that small businesses view as the most complicated. While there is some variation year to year, the specific areas of the Code that seem to be causing the most difficulty for small businesses are: (1) accounting methods (2) depreciation/expensing (including what will the rules be from year to year), (3) inventory rules and the requirement to use the accrual method if you have inventory, (4) independent contractor/employee determinations, (5) the ACA for small employers with enough employees to have to worry about these rules and (6) the rules governing retirement plans.

Recommendations

Given the challenges mentioned in my testimony, I would like to put forward two legislative recommendations: (1) a simplified method of accounting and (2) a unified tax rate schedule for all businesses no matter what their legal form.

Simplified Cash Method Of Accounting

When you look at the challenges mentioned in my testimony, it becomes readily apparent that complexity is at the heart of every one of them. This complexity stems from an effort to measure "taxable income." I believe that the single most important change that can be made to the Internal Revenue Code to profoundly simplify the tax law for small businesses, improve their ability to understand their obligations under the tax law and reduce their costs of compliance would be to adopt a "simplified cash method of accounting"(SCM) . A simplified cash method of accounting would deal directly with the complications arising from the three top areas of complexity mentioned above: accounting methods, depreciation/expensing and inventory. It would substantially simplify tax

compliance for most small businesses, allow small businesses to understand how their taxes are computed and reduce their costs.

Under current law, the cash method of tax accounting is substantially simpler than the accrual method of accounting, but it still has unnecessary complications. The most challenging of these complications is the calculation of deductible expenses. There are currently four exceptions to the general rule that a deduction is permitted when payment is made under the cash method: prepayments, depreciation, inventory, and capitalization of some expenses. For example, prepayments for property or services are not deductible if the goods or services are provided more than one year after the prepayment; and costs exceeding $5,000 associated with creating a new business are not deducted when paid but amortized over 15 years. For inventory, the costs of its acquisition or production are deducted only when the inventory to which the costs are matched is sold. Similarly, property with a useful life of more than one year that exceeds the limits for expensing (Section 179) is generally subject to depreciation, requiring its deduction be spread over recovery periods ranging from three to 39 years. Section 179 helps many small businesses but sometimes it is not enough.

The fact of the matter is the cash method of accounting is too often based not on cash receipts and disbursements, but rather on principles that attempt to match costs with income similar to the accrual method. For small businesses that have no government regulators to whom financial statements must be submitted and have no banks or other creditors that require profit and loss determinations conforming to the rules of generally accepted accounting principles, tax rules based on the accrual method serve no practical purpose, especially when economic success and taxable income can simply be measured on cash receipts and expenditures – that is, cash flow.

Small businesses would be better served by a cash method of accounting that more clearly reflects the cash flow of a small business from which taxes could be paid. Under a "simplified cash method of accounting", the computation of taxable income would be reduced to the simple following formula:

Cash Receipts *Less*: Cash Expenses including cash paid for: • Inventory • Prepayments • Materials/Supplies • Depreciable Property
Taxable Income

In short, derivation of taxable income would be based solely on cash actually received or paid during the tax year. Under this method, tax returns could be completed by simply examining the taxpayer's checkbook for when checks were written and deposits made.

The SCM would offer enormous simplification for virtually all small businesses. Under the SCM, all current expenditures, including those for the acquisition or production of inventory, would be deducted when paid. Although a technical violation of the matching principle of accounting, allowing for the immediate deduction of the cost of inventory simplifies small business recordkeeping at relatively little cost to the government. For a small business to stay in business, inventory paid for and deducted in one year likely will be sold no later than the next year to ensure sufficient cash flow for business operations. Permitting the expensing of inventory before its sale recognizes the hard fact that IRS audits reveal more than 50% of cost of goods sold calculations by small businesses are incorrect under current law. That is not likely to change unless small businesses divert even more valuable but limited resources to the maintenance of better inventory tax books and records. Allowing immediate expensing of depreciable property can be viewed as continuing 100% bonus depreciation that was available for property acquired in 2011 and expanding on the Section 179 expense allowance rules currently available for small businesses. Not only that, the latest capitalization rules issued by the IRS for determining which expenses can be immediately deducted and which must be capitalized make the current inventory rules look downright simple. These rules are just starting to go into effect so expect to hear more about them in the coming years. While the IRS has provided some relief for certain small businesses, for those businesses that do not qualify for the exception, the likelihood they will get these capitalization calculations right without spending substantial resources on professional help is remote at best. In fact, even if they do spend substantial resources on professional help, the likelihood of small businesses getting these calculations right is still remote. Finally, with respect to prepayments, some might suggest that small businesses will "manipulate" their taxable income by making prepayments at the end of the year to offset any net income. The fact of the matter is small businesses simply do not have the resources to prepay expenses in an effort to manipulate their tax liability.

Some may believe a dollar limitation on how much depreciable property or how much inventory can be expensed in a single year is necessary but from a simplification point of view limitations in these two areas would add complexity. First, they would result in taxpayers maintaining two sets of calculations, one for expenses below the threshold and one for expenses above. Second, taxpayers may end up spending time and effort focused on managing the timing of purchases from year to year to stay below the threshold. Neither of these types of behavior does anything to create jobs or grow businesses.

The following chart contrasts the current cash method and the SCM proposal for the treatment of some common business expenditures.

Type of Expenses	Current Cash Method	Simplified Cash Method
Prepayment of expenses	Deductible when paid if prepayment does not exceed one year	Deductible when payment is made
Prepayment of interest	Deductible over period it covers	Deductible when payment is made
Inventory	Capitalized	Deductible when payment is made
Business start-up expenses	Deductible up to $5,000	Deductible when payment is made
Section 179, bonus depreciation, research and development expenditures	Immediately deductible	Deductible when payment is made
Bonus depreciation	Immediately deductible (only 2011)	Deductible when payment is made unless either (1) aggregate cost of depreciable assets exceeds certain dollar threshold or (2) asset is a "long-lived asset"
Materials, supplies, and improvements	Capitalized or deducted	Deductible when paid
Expenditures related to tax-exempt income	Nondeductible	Same as current law
Expenditures contrary to public policy	Bribes, kickbacks, fines, and penalties are nondeductible	Same as current law
Political contributions and lobby expenses	Nondeductible if lobbying or political campaigning is an integral part of the business	Same as current law

Eligibility For Simplified Cash Method

Based on research we have done at the Tax Center, we believe that the appropriate level for allowing businesses to use the SCM is average gross receipts of $10 million. At that level, nearly 99% of all businesses would be eligible to use this new method of accounting.

Because most businesses would qualify for the SCM and its reduced tax compliance burdens, small businesses would be able to better maintain their **own** accounting records and prepare their **own** returns. This would reduce the need for costly tax professionals and free up more resources that could be put to work in adding jobs and growing businesses. The SCM would offer better compliance at lower cost both to taxpayers and the government, with little or no loss of tax revenue. In addition, because the calculation of tax would be understandable by small business owners it would deal with the frustration, skepticism and resentment that we see reflected in our surveys.

Apply A Single Business Tax Rate

Schedule To All Businesses Regardless Of Their Legal Form

Finally, I would like to comment on an approach to tax reform that would make sure that income from all businesses, no matter their size or legal form, would be taxed at the same tax rates. This is not as much a simplification proposal as it is a fairness proposal. Under current law, income from businesses that are conducted as sole proprietorships, partnerships and S corporations is subject to tax at a maximum rate of 39.6%, while income earned by C corporations is taxed at the maximum individual rate of 35%. Many of the proposals for corporate tax reform rely on eliminating some business deductions, preferences, and credits to increase the amount of income subject to tax, i.e. broaden the tax base, and then apply a lower corporate tax rate to that broader income base. In some of the proposals that have been discussed, the base-broadening changes that would be made would apply to all businesses, including unincorporated businesses, but the rate reductions would be made only in the corporate rate.

If corporate tax reform moves forward in this way, nearly small businesses because they are not organized as C corporations will end up with an increased tax burden when many are already struggling to stay afloat. This seems to make little sense if we are interested in enhancing the competitiveness of our economy.

The country would be better served if "corporate tax reform" is approached as "business tax reform". As part of the process of broadening the tax base and lowering the corporate tax rate, **I believe the time has come for Congress to consider a single tax rate schedule for all business income no matter what legal form a business uses to conduct business.** Given the importance of small businesses to our economy, it makes little sense that income earned by unincorporated businesses (which tend to be small businesses) is subject to tax at the higher individual rates while income earned by corporations is taxed at lower corporate rates. This is especially the case since the calculation of "taxable income" for both types of taxpayers, i.e. the determination of income and the determination of which business deductions are allowable, are virtually identical. While it is true that corporate earnings are subject to tax both at the corporate level and the shareholder level (when distributed) and earnings of unincorporated businesses are taxed only once, there are well documented approaches that can be used to effectively resolve this matter. I do not believe that the rate at which earnings from these two types of businesses are taxed should play any role in trying to reconcile the two levels of tax on corporate earnings with the single level of tax on unincorporated businesses.

A single integrated business tax rate schedule could, if so desired, use graduated tax rates, which are phased out as income rises similar to the current corporate tax rate schedule. This would provide a lesser tax burden to businesses with smaller amounts of taxable income. A single integrated business tax rate schedule would be a relatively simple system to implement and administer since the information to implement it already exists on tax returns being filed today. Income from follow-through businesses (sole proprietorships, partnerships and S corporations) already appears on separate schedules on individual tax returns. Income from sole proprietorships is reported on Schedule C and income from both partnerships and S corporations is reported on Schedule E of

the individual tax return (Form 1040). All that would be required would be for a taxpayer who is an owner of a flow-through entity to add his or her income on those two schedules (C and E) together and subject the total to the "business tax rate schedule". This would be no different in practice than how individuals who have qualifying dividend income and capital gains on schedules B and D compute their taxes today.

In short, what is needed is "business tax reform" not simply corporate tax reform. A single business rate schedule would move us toward a more comprehensive system of business taxation – one that applies to all businesses equally across the board. If done right, it could ease the tax burden of small businesses while increasing simplicity and fairness. And ultimately, that could provide small businesses with some of the relief they need in order to compete and thrive.

Summary

The biggest tax problems facing small businesses today all stem from two sources: complexity and constant change in the tax law. What our Kogod Tax Center surveys reflect is that small businesses have outsourced their tax planning and tax compliance obligations to tax professionals. The increasing demands by the IRS for greater and greater specificity as part of the tax compliance process driven by the complexity of the law and regulations are challenging even the most experienced tax professionals to maintain the quality of their work at an affordable price for their small business clients.

With 81% of tax return preparers in the survey citing the time and complexity of data gathering by their clients as a significant problem, it is clear that small business owners don't understand, or if they understand can't or won't maintain, the records required of them under the nation's tax laws. This presents a substantial challenge to the integrity of the tax system and to the small business community. When you combine this with the fact that 46% of survey respondents said "New IRS or State Regulations" decreased their efficiency this year, it seems clear that the tax system is not headed in a good direction. Tax reform is needed, and tax simplification is needed even more, for the continuing viability of our voluntary tax compliance system and, more importantly, for the continued growth and vitality of our country's small businesses.

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Thank you for allowing me to testify today. I would be delighted to address any questions from any Member of the Committee or your staff today. I and others at the Kogod Tax Center would be pleased to address any further questions with you at any future date.

Testimony of Tim Reynolds
President

Tribute, Inc.

On behalf of the National Small Business Association

NSBA
National Small Business Association

House Committee on Small Business Hearing:

"The Biggest Tax Problems of Small Businesses"

April 9, 2014

Good afternoon. I would like to thank Chairman Graves, Ranking Member Velazquez and the members of the Small Business Committee for inviting me to testify today on the biggest tax problems facing America's small businesses.

I am Tim Reynolds, owner and President of Tribute Inc., a software company located in Hudson, Ohio. Our 38 employee company develops and markets software for industrial distributors. The company focuses primarily on distributors of hydraulic and pneumatic equipment, specialty and industrial hose and rubber, and gasket products. By way of example, many customers are Eaton or Parker Hannifin distributors. Tribute develops and markets two Enterprise Resource Planning (ERP) products: the Tribute Software System, a UNIX - based solution, and TrulinX, a Windows - based solution. Both provide a fully integrated business system supporting virtually all of the distributors' business system needs.

I am proud to be here representing not only my company, but also the National Small Business Association (NSBA)—the nation's first small-business advocacy organization. NSBA is a uniquely member-driven and staunchly nonpartisan organization—where I currently serve as First Vice Chair.

Recently, there have been ambitious policy efforts in Congress to replace the current U.S. Tax Code. I welcome the eagerness of many of your colleagues to fix America's broken tax system, but I also recognize there are significant challenges with enacting comprehensive tax reform legislation in the near future. Therefore, in the interim, simplification of the most complex provisions of the Code may help to significantly reduce the burden on individual taxpayers and small businesses.

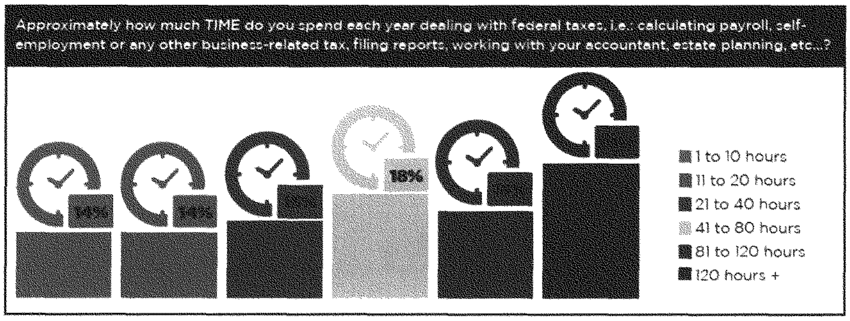
While there are many obvious problems with the current tax system, there are two paramount issues that must be addressed. The first major problem with the system is the generally high marginal rates of taxation on income. The other, perhaps more significant dilemma is the almost impossible task of compliance with all the rules and regulations. It is time that Congress acts to reexamine the Tax Code and simplify or repeal some of its most complex provisions.

Compliance Costs

Although NSBA's members operate a wide variety of businesses, they all consistently rank reducing the tax burden among their top issues for Congress and the administration to address. The compliance burden on taxpayers, because of the complexity of our Code, is truly staggering. While the actual tax liabilities for small firms is a huge issue, the sheer complexity of the tax code—along with the mountains of paperwork it necessitates—is actually a more significant problem for America's small businesses. We tend to be an easy target since, unlike big corporations which have large staffs of accountants, benefits coordinators, attorneys, personnel administrators, etc. at their disposal, small businesses often are at a loss to keep up with, implement, afford, or even understand the overwhelming regulatory and paperwork demands of the federal government and tax code.

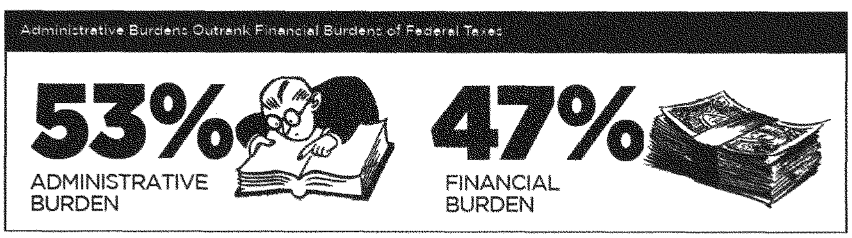
According to the just released NSBA 2014 annual Taxation Survey, 40 percent of small businesses reported they spend more than 80 hours per year dealing with federal taxes—that's

two full work weeks spent just on federal taxes. Nearly 60 percent of small firms spend more than 40 hours per year on federal taxes alone. Just imagine the collective business and job growth that could be done absent that burden.



Approximately 42 percent of NSBA members have fewer than five employees—few, if any of whom is a tax specialist—leaving business owners with no other choice but to hire outside help to keep track of all their additional reporting and filing requirements. In fact, according to the NSBA Small Business Taxation Survey, only 12 percent of small-business owners handle their taxes internally—meaning 86 percent are forced to pay an external accountant or practitioner—this data should send a strong message to the IRS and Congress that the tax code is far too complex.

Furthermore, when asked to rate the most significant challenge posed by the federal tax code to their business, the majority, 53 percent, picked administrative burdens while 47 percent highlighted financial burdens as the most significant challenges to their business posed by federal taxes. The time it takes is not the only administrative burden either, almost half report they spend more than $5,000 annually on the administration of federal taxes in the form of accountant fees, internal costs, legal fees and so on. This is before they even pay their actual taxes! In my company's case, the bill for preparing the company's taxes and my personal taxes as the owner of a Sub S corporation was $13,650.



According to a U.S. Small Business Administration (SBA), Office of Advocacy report entitled, "The Impact of Regulatory Costs on Small Firms," the compliance costs incurred by businesses are estimated to be about $95 billion annually but may be as much as 50 percent higher. Individual and not-for-profit compliance costs are, of course, quite substantial as well. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out Internal Revenue Service (IRS) forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. Small business compliance costs relative to income, revenues or per employee is disproportionately high. The SBA study quantifies this disproportionate impact, showing that the impact on small firms in terms of per employee costs are three times that of larger firms (see following table).

Tax Compliance Cost per Employee by Firm Size

	All Firms	Firms with <20 Employees	Firms with 20-499 Employees	Firms with 500+ Employees
Tax Compliance Cost per Employee	$800	$1,584	$760	$517

There will always be some compliance costs in any tax system. But today these costs are very high and if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

These costs also represent a significant drag on the economic growth, on job creation and on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress.

Fair Tax

Clearly, the current tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes, with widespread competitive disadvantages to small firms. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

To that end, NSBA was the first small-business organization in the country to support the Fair Tax (*H.R. 25*)—a national 23 percent tax on the end point-of-sale for all goods that would

replace all current individual and corporate tax schemes. It would dramatically reduce the tax bias against work, savings and investment, and would substantially reduce complexity and compliance costs. Additionally, the Fair Tax would make the U.S. an extremely attractive location to manufacture goods and put U.S. produced products on even footing with foreign produced goods. The majority of small firms (53 percent) expressed support for the Fair Tax in NSBA's Small Business Taxation Survey.

Principles of Tax Reform

While we firmly believe the Fair Tax is the best path forward, NSBA understands the political landscape and need to move forward on broad reform, even if in a different iteration. As such, NSBA has developed nine principles as part of the NSBA Tax Reform Checklist to which any broad tax reform package ought to adhere. The nine principles are:

- Designed to tax only once
- Stable and predictable
- Visible to the taxpayer
- Simple in its administration and compliance
- Promote economic growth and fairness between large & small businesses
- Use commonly understood finance/accounting concepts
- Grounded in reality-based revenue estimates
- Fair in its treatment of all citizens
- Transparent

This kind of broad reform is what small firms want: according to NSBA's Small Business Taxation Survey, 67 percent expressed support broad reform of the tax system that reduces both corporate and individual tax rates, coupled with reducing both business and individual deductions.

All Tax Credits are Not Created Equal

According to NSBA's tax survey, the majority of small businesses, 59 percent, say that federal taxes and credits or deductions have a significant to moderate impact on their business decisions while 73 percent say federal taxes have a significant to moderate impact on the day-to-day operation of their business. However, many NSBA members have commented that the complexity, continually changing and temporary nature of many credits and deductions are diminishing their importance.

The discussion of tax policy must not occur in a vacuum. NSB A is firmly committed to seeing the deficit reduced, and as such, we believe it is important to promote those tax credits that stand to offer the most benefit to the most people, both directly and indirectly.

While there are a number of tax deductions, credits and exclusions that are very beneficial to small-business growth and overall economic stimulation, some do little to promote economic growth. They may have other policy objectives and may or may not achieve those objectives, but

they do not materially affect the incentives to work, to save or to invest. One in particular that, while good-intentioned, does not offer broad relief is the hiring tax credit whereby a firm would receive a credit for hiring a previously unemployed individual. Small firms are unlikely to hire a new person simply for that tax credit – those that are in a place to hire will likely do so regardless of a temporary, one-time credit, and they will look for the person best suited with the appropriate skills. Unfortunately, if that person isn't among the long-term unemployed, that will not likely be a factor in the employer's decision making process.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace. It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind their domestic and foreign competitors, the firms will simply fail.

Not only do these kind of investment-spurring tax credits and deductions help the qualifying firm, it helps promote economic growth by encouraging firms to make investments and purchase equipment from other firms. These tax provisions are the epitome of stimulatory.

Please indicate your level of support for each of the following tax reform proposals

	SUPPORT	DON'T SUPPORT	NOT SURE
Reduce both corporate and individual tax rates, and reduce both business and individual deductions	67%	19%	14%
A broad reform of the tax system in-line with the Fair Tax (elimination of all income and corporate tax rates as well as all deductions, and instead implement a 23 percent tax on the end point-of-sale for all goods)	53%	25%	22%
Reduce the corporate tax rate and eliminate some business deductions	47%	23%	29%
Moving the current U.S. tax system from a "worldwide" tax system, in which all income is taxed regardless of its origin, to a "territorial" system, in which all foreign-source income is exempted from tax	18%	50%	32%
A European type value added tax	11%	50%	39%

Taxation of Pass-through Entities

Most small businesses are sole proprietorships, subchapter S corporations—such as Tribute Inc.—or limited liability companies. Most of the remainder are partnerships (either limited or general). There also are some business trusts. All of these businesses (83 percent, according to NSBA data) pay taxes on their business at the personal income level, or are so-called "pass-through" entities that are subject to individual tax rates – not corporate tax rates. It is no surprise then, that income taxes were ranked the most burdensome administratively, while payroll taxes were ranked the most burdensome financially, by small firms.

Some small businesses are C corporations that are subject to the corporate income tax, but these are a relatively small percentage and a large portion of these companies' net income before compensating the owners' is usually consumed by paying the owners' salary. This salary is also subject to the individual tax rates as, of course, are any dividends paid by the corporation to its shareholders. Thus, even for small C corporations, individual tax rates are key.

Broad reform of the entire tax code is necessary, not just for corporate entities. Allowing the smallest businesses to pay a much higher tax on their business income than a multinational, multi-billion corporations undercuts any semblance of fairness. Many proposals have called for reducing the corporate tax rate while eliminating various business deductions and credits, which—if not examined more closely—sounds like a fine plan. However, many pass-through entities, small businesses, utilize these tax benefits that would be on the chopping block. So now I would be facing the same, high tax rate on my business income, but I could no longer take advantage of some important tax credits and/or deductions. The result is a tax increase on my firm while large corporations would be given a tax cut.

I firmly believe that addressing just one piece of the puzzle—such as corporate tax reform—will only lead to even greater complexity and a massive tipping of the scales in favor of the nation's largest companies at the expense of small businesses.

Imposing higher tax rates on small firms will stymie any growth from what is widely recognized as the source of much of the economic growth and dynamism in the U.S. economy: small business. For the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates. Since small businesses disproportionately contribute to job creation, raising individual marginal tax rates can be expected to have a disproportionate negative impact on job creation. It is this kind of shortsightedness that has made the IRS a major foe of small firms and why so many of us support broad tax reform.

If Congress overhauls the tax system by dramatically broadening the base — cutting the breaks that litter the tax code—and lowering rates, we would see real economic growth and raise revenues.

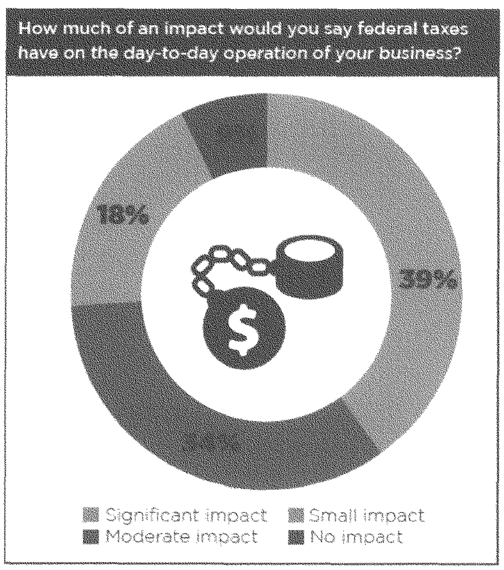
Which of the following deductions or credits do you take advantage of? (Check all that apply)

Sec. 179 expensing	34%
Home mortgage interest deduction	31%
Home office deduction	22%
Bonus depreciation	20%
15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and qualified retail improvements	13%
R&E (Also called R&D) credit	8%
Energy efficiency credits	8%
Start-up costs deduction	8%
Work Opportunity Tax Credit	3%
None of the Above*	27%
Other	4%

*The ongoing debate over the so-called "tax extenders" holds significant importance for small businesses as the majority, 73 percent, report utilizing some kind of tax benefit covered under the extenders umbrella

Tax Extenders

As a software development company, Tribute spends a significant amount of time, money and resources each year on research and development. As such, we are entitled to take advantage of the Research and Experimentation (R&E) tax credit, which can produce significant tax savings to innovative companies such as mine. As most small innovators, we are always trying to improve what we do, be more competitive, reduce costs and increase market shares. However, because we are a sub chapter S corporation and the income of the business passes thru to my personal income taxes, I am always subject to the Alternative Minimum Tax (AMT). This prevents my company from taking the R&E credit, or we are limited to such a small amount each year that our accounting firm now no longer even calculates what the credit might be. The costs of calculating the credit usually would exceed the allowable credit. The R&E tax credit is meant to encourage additional research and development, yet I am penalized for the way I structured my business. Small businesses are often America's greatest innovators, and yet the complicated tax code steps on its own foot in this area.



Now, even if I wanted to take the R&E tax credit I can't because on Dec. 31, 2013 it expired, along with more than 55 other tax provisions commonly referred to as "tax extenders." The loss of some of these vital credits will negatively impact job creation, investment, research and international competitiveness. It's no wonder so many small firms say federal taxes have a significant impact on the day-to-day operation of their business—and no wonder why so many small firms are beyond frustrated with the Tax Code.

While most of these tax incentives have been extended several times in recent years and even expanded to help small businesses manage throughout the economic downturn, it often has been done retroactively and in a rushed manner, leaving many small firms scratching their heads on how to plan for the upcoming year. Now, however, these provisions have been expired for several months and by Congress continuing to further delay there extensions, it punishes our work, investment, risk-taking and entrepreneurship.

Due to budgetary and political restraints, too many of these provisions were enacted on a temporary basis, requiring repeated extensions. The uncertainty resulting from such temporary tax policy makes it difficult for small businesses to plan effectively for the future, creating

significant uncertainty and making it difficult to remain competitive in an increasingly global marketplace.

Section 179 Expensing

Section 179 expensing is one of the most important provisions in the tax code to small businesses. It simplifies tax accounting, aids cash flow and reduces the cost of capital for small firms. Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensive industries. More than one in three NSBA members take advantage of this break as it encourages small businesses to invest in new equipment by letting them expense much of the cost up front, instead of depreciating it over time.

For Tribute, it has its largest impact on our sales. We sell ERP software to industrial distributors. The software we sell is typically my customer's second largest investment in their business, behind only their investment in inventory, and is eligible for the benefits allowed under Section 179. This deduction often is the difference between affordable and not, and our customers often plan several years in advance for this very significant purchase and implementation. The annual termination, change in limits and delayed extension of this and other tax extenders disrupts this planning, interferes with business efficiency improvements and harms the economy both for buyers and sellers of capital goods.

Section 179 eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. For 2013, up to $500,000 of investment purchases was deductible. However, in 2014, the figure fell to an unacceptably low $25,000. This lower threshold dramatically limits the number of firms that can appreciably benefit and significantly reduces the economic effect of the provision.

Which of the following deductions or credits do you think are most important to stimulating small-business growth? (check all that apply)

Allow full deduction for health insurance costs for self-employed	62%
Sec. 179 expensing	36%
Start-up costs deduction	32%
Bonus depreciation	31%
Home mortgage interest deduction	25%
Work Opportunity Tax Credit	25%
Home office deduction	22%
15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and qualified retail improvements	22%
R&E tax credit	17%
Energy efficiency credits	17%
Other	17%

Self-employed Health Insurance Deductibility

Self-employed individuals (including partners and LLC members), unlike large corporations, cannot fully deduct the cost of their health insurance as a business expense. At issue is the 15.3 percent tax that self-employed individuals must pay on their employer-provided health insurance costs to which nobody else is subjected. The self-employment tax rate on net earnings is the sum of 12.4 percent for Social Security (old age, survivors, and disability insurance), and 2.9 percent for Medicare

(hospital insurance).

While the important 2003 change enabled small-business owners to deduct the cost of health care from their income that income already has been exposed to the payroll tax. Thus, the self-employed pay the self-employment tax on income used to purchase health care. The self-employed pay an average of $12,680 per year for health insurance. Because they cannot deduct this as an ordinary business expense, the 15.3 percent payroll tax they alone pay on their premiums amounts to $1,940 in extra taxes that only the self-employed pay. This is money that could be used to reinvest and grow the business, hire part-time help or cover the ever-increasing costs of health insurance. This additional 15.3 percent tax makes already disturbingly high-priced health care cost even more by adding thousands of dollars to the cost of an individual's health care.

Furthermore, according to the NSBA tax survey, small firms rated the full deductibility of health insurance costs the number one most important deduction or credit when it comes to stimulating small-business growth.

Deficit Reduction

Reducing the deficit is another top priority for America's small businesses, inextricable from the tax reform debate. The U.S. has always been a leader in entrepreneurship, however, if we do not address our record-high national debt and annual budget deficits, our global competitiveness will be stymied.

The nation's long-term economic health cannot be assured unless the government gets control of its most costly entitlement programs. In light of many contributing factors: health care costs growing faster than the economy; the aging and increased life-expectancy of a Baby Boom generation reaching retirement eligibility; negative personal savings rates; and the fact that 55 percent of the elderly currently rely on Social Security for the majority of their income, Social Security and Medicare will be unsustainable in the long-run absent significant reforms.

Even with an economic recovery and the ensuing increase in tax revenues and decrease in spending on stimulative and safety net programs—without major changes—federal spending will continue to outpace revenues. If we continue to run high deficits, increased interest rates and constricted credit will negatively impact small businesses' ability to garner financing, the life-blood of every small firm. And this inability has real-world implications for all of us: based on NSBA data from as far back as 1993, there is a direct correlation between small firms' ability to get financing and their job growth. When small firms can't access financing, they don't hire.

To address the deficit, the two proposals supported by the majority of small businesses are: an across-the-board cut for federal agencies; and eliminating all tax credits and deductions in conjunction with dramatically lower income tax rates.

Conclusion

Complexity and inconsistency within the tax code pose a significant and increasing problem for small businesses. The ever-growing patchwork of credits, deductions, tax hikes and sunset dates

is a roller coaster ride without the slightest indication of what's around the next corner. Without either renewal of the tax extenders or comprehensive tax reform, the investment and hiring decisions of businesses must be made in an uncertain and confusing business environment. This is unsustainable and unacceptable.

The debate on fundamental tax reform will continue well into the next Congress. However, unless and until Congress agrees upon a replacement, we must fix tax problems with the current Tax Code by developing simplification measures that are fair and fiscally responsible.

Weighing in at more than 70,000 pages, the tax code punishes work, investment, risk-taking and entrepreneurship. The Tax Code is unfair to small businesses, biased against savings and investment, and impossibly complex. A tax system dedicated to investment, savings and small-business growth must be put in its place.

I would like to mention specifically House Ways and Means Chairman Dave Camp (R-Mich.) and applaud his efforts over the last few years to garner stakeholder input, go through the very difficult and time-consuming work to craft reform language, and push forth on the need for lawmakers to work together to achieve some tax relief. Additionally, on the other side of the Capitol and other side of the aisle, Senate Finance Committee Chairman Ron Wyden (D-Ore.) has been a leading proponent on broad tax reform, dating back to the Wyden-Coats reform bill from several years ago.

Standing on the sideline and lobbing stones is easy—digging in and doing the work is hard, and something small-business owners do every day. I'd like to encourage every member of this committee to reach out to Chairman Camp and offer your support and input. More than that, I encourage you to reach across the aisle and work with your cohorts to solve this problem.

Again, I would like to thank Chairman Graves and the members of the Small Business Committee for the opportunity to speak today. I would be happy to answer any questions you may have.

the ascii group inc.

The IT Community

The ASCII Group, Inc.

Testimony of Rick Endres
President, The Washington Network, Inc.

Before the
U.S. House of Representatives
House Committee on Small Business

"The Biggest Tax Problems of Small Businesses"

April 9, 2014

The Washington Network Inc.
TELEPHONE SYSTEMS & COMPUTER NETWORKS

Introduction

Good afternoon, Chairman Graves, Ranking Member Velázquez, and distinguished members of the Committee. My name is Rick Endres, I appear on behalf of my company The Washington Network, Inc., and as a member of The ASCII Group, the nation's oldest community of small and medium sized information technology (IT) solution providers.

I want to thank Chairman Graves and Members of this Committee for holding this hearing on tax issues facing small business. The complexity of the tax code and the difficulty of complying with it are challenges that I face on a regular basis, and it is a challenge that affects my business, my fellow ASCII members, and millions of other small businesses across the country.

Small businesses continue to be the largest job producers in the country. As you know, there are 28 million small businesses in the United States, and the small business community has provided millions of good-paying jobs for Americans at a time when big business continues to eliminate jobs.

I would like to share with you my experiences on behalf of my company and The ASCII Group on the difficulties the tax code presents small businesses in terms of growing our companies and the effect it has on our ability to employ more people.

About The ASCII Group

The ASCII Group is a membership-based community of independent managed service providers, value added resellers, and other IT solution providers. Formed in 1984, ASCII brings together over 1,000 SMB IT integrators and these IT solution providers, located in every state of this country, provide integrated IT solutions for many thousands of businesses, educational and government entities, daily. ASCII provides its members educational information; group purchasing power; increased leverage in the marketplace; and multiple networking opportunities.

ASCII provides several ways for SMB companies like The Washington Network to communicate with each other, and we have learned from talking to each other that we each share the daunting task of fully complying with the maze of federal, state and local tax laws.

On a state level, members recently asked ASCII to contact each state tax division with nearly two dozen questions related to uncertainties about when they should be charging taxes for services provided to their clients. For companies like mine who do business in the DC area, that means incurring the cost of staying updated on various tax interpretations and laws in Virginia, Maryland, and the District of Columbia. On a federal level, the challenge is just as difficult because of uncertainties with the ever-changing tax code and the ever-increasing number of regulations.

ASCII realized the marked effect the complex federal tax code has had on the success of its members and so became involved due to the efforts led by CompTIA (the Computing Technology Industry

Association) through their TechVoice initiative. TechVoice raises awareness on Capitol Hill about issues such as the tax code facing the SMB IT community. Small business owners work an incredible amount of hours, and every hour and every dollar spent on trying to figure out how to comply with the tax code is time not spent on growing their business so they can hire more people.

The Effects of a Complex Federal Tax Code

Founded in 1987, my company, The Washington Network, is an IT consulting firm that supports the computer networks and telephone systems of Washington DC area businesses. During our 27 years in business we have provided IT support to hundreds of companies and employed dozens of people.

While I would consider my company to be a true example of a successful small business entrepreneur, I also consider myself to be the prototypical victim of an uneven tax code that is filled with uncertainty, vagueness and unintended consequences for me and other small IT companies. The complexity of the tax code has had a negative impact on both my business growth and my hiring capabilities.

This is true even for areas of the code that were meant to stimulate job growth. Tax credits designed to help my business often go unused because of the complexity of learning how to take advantage of them.

Seven Tax Burden Examples from the Front Lines of Small Business

1 - Unworkable Compliance Time Frame

The "Hire Veterans Tax Credit" encourages us to hire an unemployed veteran. A worthy incentive, however, this little known credit takes many billable hours to comply with; and if you don't file Form 8850 *within 28 days of hiring,* you're disqualified from the credit.

You would think that you'd be able to file Form 8850 for the tax year—right? No—have to file within 28 days. While we still look to hire veterans we won't be pursuing the credit.

2 - Remarkable Complexity

Filing the 10-page Form 8941 for Small Employer Health Insurance Credit is my "Poster Child" for needless complexity. The amount of information that I have to assemble *to see if I even quality* is mind-boggling. In 2007 the IRS calculated over 30 hours to comply. In 2013 they claim it can be done in less than 15 hours.

My accountant can do it for me in under 10 hours. So why would I pay $1,500 to get a $500 credit? Why not just say—if you are a small business under 25 employees and supply health insurance for your employees we'll give you a 10% credit. Why the Rube Goldberg complexity? The only beneficiaries are the accountants. Any wonder that many business-boosting credits don't have their intended effect?

I think that Congress should consider tax preferences for small business but only to the extent that they are usable by real companies in real world situations and won't require extraordinary effort to access them.

3 - Instability of the Tax Code - Moving Targets

I am making business investment decisions without having any knowledge of how ultimately the tax code is going to tax me or my clients. The Section 179 deduction is back down to $25,000... that a 1950s number. It needs to be expanded back to $500,000 and above all it should be made permanent. Today's technologies change too rapidly for the current out-of-date depreciation schedules.

4 - Capital Formation Disincentive

If you are a Sub-Chapter S Corporation the tax code does not allow keeping some retained earnings in the business for a rainy day or to fund future growth. There needs to be a portion of the K–1 that is not taxed at the highest rates.

5 - Unintended Consequences Limits Hiring

The tax code has a chilling effect on the number of employees I will hire. Although our employee count has varied over time, we never plan to grow beyond 30 employees in an effort to stay under regulatory and tax code radars. While we make every effort to comply with the tax code, there are so many regulations and expenses involved in trying to comply with the code that we have turned down opportunities to grow due to the potential implications and the increased accounting and legal fees in determining what our new tax responsibilities would be under the code.

6 - Many Definitions of Small Business in Federal Law

Another area that would greatly help small businesses is the elimination of uncertainty that permeates the tax code. It's extremely frustrating when even simple things like trying to determine whether I am considered to be a 'small business' can be confusing since the government has so many definitions of what a 'small business' is. Depending on the law or regulation, a small business threshold is generally defined as anywhere from 11 employees to 50. The SBA definition is 499 employees and below. This uncertainty eats away at my profits as I spend money on legal and accounting fees to make sure I am in compliance with the law. I know a number of companies that have spent a great deal of money to split their companies in two to avoid head counts over 50. Those costs to avoid punitive thresholds add nothing to their ability to improve their products and increase their competitiveness.

7 - Need Time to File a Quality Tax Return

Finally, decreasing the amount of paperwork and being sensitive to the time/money factors that a small business faces would be very helpful. One change in the code that would help small businesses, for instance, is if there could be an extended deadline for annual returns. While taxes should obviously be paid on time, quality corporate returns often cannot be done by March 15th. Most data is pouring in until the first week in February and our accountant

needs a couple weeks to prepare along with the crush of all their other clients. So business stops for two or three weeks for many of us while we close our books and prepare for our filing. That deadline should be extended a few months to give small businesses and their accountants more time to prepare a higher quality return.

Furthermore, the quarterly filing of payroll taxes doesn't seem to have any practical utility and adds unnecessary filing costs.

Conclusion

So in conclusion, as a small business owner I am concerned that I will need to continue to divert more resources to make sure I comply with the ever-growing complexity of the tax code. I would ask the Committee to consider sensible changes that will allow me and other IT small business owners to focus more energy on company and job growth and less energy and dollars on figuring out how to make sure I conform with the code.

Contact: RickEndres@WashingtonNetwork.com

Tax Issues Facing Small Business

Donald B. Marron*
Urban Institute &
Urban-Brookings Tax Policy Center

Testimony before the Small Business Committee,
United States House of Representatives

April 9, 2014

Chairman Graves, Ranking Member Velázquez, and Members of the Committee, thank you for inviting me to appear today to discuss tax policy and small business.

America's tax system is needlessly complex, economically harmful, and often unfair. Despite recent revenue gains, it likely will not raise enough money to pay the government's future bills. The time is thus ripe for wholesale tax reform. Such reform could have far-reaching effects in the economy, including on small businesses. To provide context for evaluating those effects, my testimony offers six main points about the tax issues facing small business:

- Tax compliance places a large burden on small businesses, both in the aggregate and relative to large businesses. The Internal Revenue Service (IRS) estimates that businesses with less than $1 million in revenue bear almost two-thirds of business compliance costs and that those costs are larger, relative to revenues or assets, for small firms than for big ones.

- At the same time, small businesses are more likely to underpay their taxes. Because they often deal in cash and engage in transactions that are not reported to the IRS, small businesses can understate their revenues and overstate their expenses and thus underpay their taxes. Some underpayment is inadvertent, reflecting the difficulty of complying with our complex tax code, and some is intentional. High compliance costs disadvantage

* Director of Economic Policy Initiatives and Institute Fellow, Urban Institute; former Director of the Urban-Brookings Tax Policy Center. The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its funders, or its trustees. William Gale, Joe Rosenberg, Eric Toder, and Roberton Williams provided helpful comments and John Guyton recommended some data, but all errors are my own. This testimony updates some text in an earlier testimony (Marron 2011) and builds on work by my Tax Policy Center colleagues (Gale and Brown 2013; Toder 2008).

responsible small businesses, while the greater opportunity to underpay taxes advantages less responsible ones.

- The tax code offers small businesses several advantages over larger ones. Provisions such as Section 179 expensing, cash accounting, graduated corporate tax rates, and special capital gains taxes benefit businesses that are small in terms of investment, income, or assets.

- Several of those advantages expired at the end of last year and thus are part of the current "tax extenders" debate. These provisions include expanded eligibility for Section 179 expensing and larger capital gains exclusions for investments in qualifying small businesses.

- Many small businesses also benefit from the opportunity to organize as pass-through entities such S corporations, limited liability companies, partnerships, and sole proprietorships. These structures all avoid the double taxation that applies to income earned by C corporations. Some large businesses adopt these forms as well, and account for a substantial fraction of pass-through economic activity. Policymakers should take care not to assume that all pass-throughs are small businesses.

- Tax reform would likely shift the relative tax burden of small and large businesses and recalibrate the tradeoff between pass-through and C corporation structures. A revenue-neutral business reform that lowers the corporate tax rate while reducing tax breaks would likely favor C corporations over pass-throughs and might well reduce some tax preferences targeted at small businesses. The net effect will depend, however, on the details and may vary among businesses of different sizes, industries, and organizational forms. Reform provides an opportunity to reduce compliance burden on small businesses.

I elaborate these points in the remainder of my testimony.

1. Small businesses face high costs complying with the tax code, both in aggregate and relative to large businesses.

Complying with the tax code is expensive. IRS researchers recently estimated that corporations and partnerships spent more than $100 billion complying with the

federal income tax for tax year 2009 (Contos et al. 2012).[1] That figure includes both out-of-pocket expenses and the value of worker time devoted to compliance.

Table 1. Federal Income Tax Compliance Costs for Businesses, 2009

	Compliance Costs		Number of
	Total ($ billion)	Average ($ thousand)	Businesses (million)
All businesses	104	12	9.0
By size of receipts			
$0 - $100,000	26	5	4.9
$100,000 - $1 million	40	13	3.2
$1 million - $10 million	25	34	0.7
$10 million - $500 million	11	128	0.1
$500 million +	2	925	*
By size of assets			
$0 - $100,000	23	5	5.0
$100,000 - $1 million	32	12	2.6
$1 million - $10 million	30	27	1.1
$10 million - $500 million	16	78	0.2
$500 million +	4	468	*

Note: Numbers may not add or multiply due to rounding; * = fewer than 10,000.

Source: Contos et al. (2012) and author's calculations.

Small businesses bear the majority of those costs (Table 1). Businesses with less than $1 million in revenue bore almost two-thirds of business compliance costs—$66 billion—a figure that rises to $91 billion for all businesses with less than $10 million in revenue. Those aggregate costs are driven by the sheer number of small businesses. Of the 9 million businesses that the authors identified in 2009, almost 5

[1] These estimates rely on several important assumptions, including the accuracy of underlying survey data, the estimated cost of worker time, and the ability to distinguish tax record-keeping from accounting and reporting activities that companies would have done anyway. Alternative assumptions would change the estimated compliance burden, but would not change the two main findings: compliance costs are large and small businesses bear a larger relative burden than do large businesses. Of particular note is Contos et al.'s (2012) assumption that the average worker in a small firm has a lower hourly wage than one in a large firm. This differs from previous studies that assume equal wage rates, such as the oft-cited estimates in DeLuca et al. (2007). Those earlier estimates found an even-more disproportionate compliance burden on small businesses.

million had revenues less than $100,000, and slightly more than 8 million had revenues less than $1 million.

As you would expect, compliance costs increase with business size. A typical firm with revenues less than $100,000 incurs about $5,000 in compliance costs, one with revenues of $1 million to $10 million incurs about $34,000, and one with revenues above $500 million incurs an average of more than $900,000. A similar pattern holds comparing businesses based on the value of their assets.

These figures confirm previous research that found substantial economies of scale in tax compliance (Slemrod and Venkatesh 2002; DeLuca et al. 2007). Compliance costs are larger for bigger firms, but they grow much less rapidly than do revenues or assets. For partnerships with assets of $100,000 to $1 million in 2009, for example, annual compliance costs averaged 3 percent of assets.[2] For partnerships with assets between $1 million and $10 million, that ratio fell to less than 1 percent. And for partnerships with assets more than $10 million, it was less than 0.1 percent. Tax compliance thus places a bigger relative burden on small firms than on large ones.

2. Small businesses are more likely to underpay their taxes.

The IRS (2012a) estimates that taxpayers underpaid their federal taxes by $450 billion for tax year 2006.[3] Small businesses accounted for a substantial portion of that gap (Table 2). Underreporting by sole proprietorships, partnerships, and other types of businesses whose income is reported on individual tax returns accounted for $122 billion. Underreporting by small C corporations (those with assets less than $10 million) added another $19 billion. Underreporting of self-employment taxes added $57 billion. Together, those three categories of underreporting by small businesses and the self-employed total almost $200 billion.

One reason for this gap is that transactions with and by smaller firms, particularly sole proprietorships, are often not subject to IRS reporting and withholding requirements. In addition, they often deal in cash. As a result, it is much easier for them to underreport revenues and overstate expenses and thus underpay their

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[2] These figures are based on average compliance costs for partnerships (Contos et al. 2012) and average assets (IRS 2011). Compliance costs relative to assets are higher still for partnerships with less than $100,000 in assets, but data limitations prevent me from giving a specific figure.

[3] The IRS (2012a) estimates that through enforcement actions and late payments, IRS will recover $65 billion of those underpayments, leaving a net tax gap of $385 billion.

taxes. Given the complexity of the tax code, some of this underpayment is undoubtedly inadvertent. Indeed, GAO has estimated that 9 percent of sole proprietors overstated their income in 2001 and, in a somewhat similar context, a third of individual investors who misreported security sales overstated their gains or understated their losses. Those errors are presumably unintentional. Of course, some small businesses underpay intentionally. Small businesses that are willing to engage in tax evasion can thus have an advantage over larger firms that have more transparent systems for monitoring and reporting income and over small businesses that play by the rules.

Table 2. Sources of the Tax Gap, 2006

	Tax Gap ($ billion)
Underreporting	
Individual Income Tax	
Business Income	122
Non-Business Income	68
Credits, Deductions, Exemptions, Adjustments	45
Corporate Income Tax	
Large Corporations (assets ≥ $10 million)	48
Small Corporations (assets < $10 million)	19
Employment Tax	
Self-Employment	57
FICA and Unemployment	15
Estate Tax	2
Underreporting	***376***
Nonfiling and Underpayment	
Individual Income Tax	61
Employment, Corporate, Estate, Excise	13
Nonfiling & Underpayment	***74***
Total	**450**

Source: Internal Revenue Service (2012a) and author's calculations.

Research confirms that document matching and withholding significantly affect compliance. The IRS (2012a) estimates that taxpayers report less than half of their income when it is subject to little or no document matching; that category includes sole proprietors and farms (Table 3). Taxpayers report almost 90 percent of income

Table 3. Information Reporting and Individual Income Tax Compliance, 2006

	Fraction of Income Reported	Tax Gap ($ billion)
Little or No Information Reporting Sole proprietors, farms, rents & royalties, adjustments, Form 4797, other	44%	120
Some Information Reporting Partnership income, capital gains, deductions, exemptions, alimony	89%	64
Substantial Information Reporting Pensions, annuities, dividends, interest, Social Security, unemployment insurance	92%	12
Substantial Information Reporting and Withholding Wages and salaries	99%	11

Source: Internal Revenue Service (2012a) and author's calculations.

that is subject to some information reporting, a category that includes partnerships. Reporting rises to 99 percent for wages and salaries, which are subject to both information reporting and withholding.

IRS's tax gap estimates have sparked some criticism. Small Business Administration research suggests, for example, that earlier IRS estimates may have understated the tax gap created by large businesses and thus overstated the relative importance of small business (Quantria Strategies 2011). More recently, the Treasury Inspector General for Tax Administration (2013) reviewed the current IRS methodology and noted that it had made some improvements in both data and methodology. However, TIGTA also raised concerns about estimating the tax gap for large, international corporations and about distinguishing the tax gap for businesses engaged in otherwise legal activities from those engaged in illegal ones. Addressing those concerns could change the relative amounts of the tax gap attributed to large and small businesses, but would not eliminate the basic facts that underpayment by small businesses is a significant contributor to the tax gap and that non-compliance as a share of taxes owed is larger for smaller than for larger businesses.

3. The tax code favors small businesses in several important ways.

The tax code favors businesses that are small in terms of investment, income, or assets. The most important such preferences include Section 179 expensing, cash accounting, graduated corporate tax rates, and special capital gains treatment.[4]

- *Section 179 expensing.* Under Section 179, businesses can deduct from their taxable income the full cost of qualifying investments up to a specified dollar limit; those investments would otherwise need to be capitalized and written off over time. Such expensing benefits firms by reducing their tax liabilities immediately and eliminating the record-keeping burden of tracking basis and depreciation. In 2013, the maximum amount that firms could immediately expense was $500,000; this benefit was then taken back dollar for dollar for investments in excess of $2 million. Those temporarily higher limits, and some expansions in eligible investments, expired on December 31, 2013. If Congress does not extend them, the relevant limits for 2014 and beyond are much less generous: a maximum of $25,000 in investment, phasing out beginning at $200,000. Under today's law, firms thus benefit from Section 179 if they make less than $225,000 in qualifying investments; in 2013, that figure was $2.5 million.

- *Cash accounting.* If a business involves inventory, it must use accrual accounting for federal tax purposes. The tax code provides exceptions, however, for small firms. Businesses whose revenues averaged no more than $1 million over the previous three tax years can use cash accounting, as can some firms with average revenues as high as $5 million or $10 million (IRS 2012b). Many firms find cash accounting easier to implement than accrual accounting, so this provision helps reduce compliance burdens. Cash accounting also allows many firms to claim deductions for inventory costs sooner than they would under accrual accounting.

- *Graduated corporate tax rates.* Corporate income tax rates are 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and 34

[4] Other small business benefits include exemption from the corporate Alternative Minimum Tax, amortization of business start-up costs, a tax credit to help small businesses enroll employees in retirement plans, a tax credit for employers to make business more accessible to disabled workers, and some additional capital gains relief. See Gale and Brown (2013) for details.

percent up to $10 million.[5] These rates are lower than the 35 percent that applies to larger corporations. The tax code thus favors corporations with small profits over those with larger profits. In some cases, these businesses are owned by high-income individuals who would pay higher current rates on their income if it were subject to individual income tax.

- *Lower capital gains taxes.* The tax code offers favorable treatment to some capital gains from individual investments in small businesses. For investments made in 2013, capital gains (up to the larger of $10 million or ten times the taxpayer's basis in the stock) resulting from new equity investments in qualifying small businesses (C corporations with less than $50 million in assets) were exempt from income taxes if the stock is held for more than five years. For new investments, that treatment expired on December 31, 2013. Unless reinstated, this provision will return to permanent law which excludes 50 percent of such gains from taxation.

As noted, both Section 179 expensing and lower capital gains taxes for investments in small business are part of the current discussion of the "tax extenders," several dozen temporary tax preferences that expired at the end of last year.[6]

4. The tax system favors pass-through entities over C corporations.

The tax system distinguishes among businesses based on how they are organized. S corporations, partnerships, limited liability companies (LLC), and sole proprietorships do not pay the corporate income tax. Instead, their profits are reported and taxed on the returns of their owners. The earnings from pass-through entities thus escape the double taxation that otherwise can apply to the income of C corporations.

To illustrate, consider a small business owner in the top 39.6 percent personal income tax bracket. If she structures her business as an LLC, she will pay about 40 cents in personal taxes and retain about 60 cents of net income on each additional dollar that her business earns. If she structures her business as a C corporation, however, the income will face two layers of tax. The business will pay a 35 percent corporate income tax on each additional dollar of earnings. The 65 cents in after-tax

[5] A 5 percent additional tax between $100,000 and $335,000 recaptures the benefits of the 15 and 25 percent brackets. A 3 percent additional tax between $15 million and $18.3 million recaptures the benefits of the 34 percent bracket.

[6] For a general framework for thinking about the tax extenders, see Marron (2011).

income is then subject to personal income taxes when it gets distributed to the owner. Any earnings distributed as dividends, for example, would be taxed at a top personal rate of 23.8 percent, including both the regular dividend rate of 20 percent and the 3.8 percent net investment income tax enacted to fund healthcare reform.[7] If the company paid out all 65 cents in after-corporate-tax income as dividends, the resulting personal taxes would be about 15 cents. The owner's after-tax income would thus be only 50 cents from a C corporation versus 60 cents from an LLC. The difference between a 50 percent effective tax rate and a 40 percent rate is a powerful incentive to structure as a pass-through.[8]

That's one reason that most small businesses organize themselves as pass-throughs. But that doesn't mean that all pass-throughs are small businesses. Some large, closely-held businesses also organize themselves as partnerships, S corporations, LLCs, or even sole proprietorships. As noted in Marron (2011), these large pass-throughs are few in number but account for a large fraction of the economic activity pass-throughs undertake. Policymakers should therefore take care not to equate pass-throughs with small business.

5. Tax reform will likely shift the relative tax burdens of small and large businesses and recalibrate the choice between pass-through and C corporation structures.

The past few years have witnessed a growing consensus on the need for wholesale tax reform. People differ greatly in the details of their proposals, but one common theme is the idea of rolling back tax breaks and using the resulting revenue for some combination of tax rate reductions and deficit reduction. In various ways, that approach was endorsed by the Bowles-Simpson Commission, the Rivlin-Domenici Task Force (on which I served), President Obama in his business tax proposal, and, most notably, in Ways and Means Chairman Dave Camp's comprehensive reform proposal.

It is difficult to make any sweeping claims about the effects of tax reform on small business. The net effects will depend on the details and may well vary by size,

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[7] The phase-out of itemized deductions for high-income taxpayers, known as Pease, can lift the top effective marginal rate another 1.2 percentage points to a total of 25 percent.

[8] This comparison highlights the potential double taxation but excludes other factors that might reduce the tax difference. Most importantly, the owner could retain some of her earnings in the company rather than paying them out as dividends. That delay would reduce the difference in effective tax rates.

industry, and organizational form. Still, a few themes seem evident from the discussion thus far.

- A revenue-neutral business reform that lowers the corporate rate while eliminating business tax preference will reduce taxes, on average, for C corporations and increase them on other businesses. The reason is simple: lowering the corporate tax rate reduces taxes only on C corporations, while reducing preferences increases taxes on all businesses. This effect may cause some closely-held businesses to organize as C corporations rather than pass-throughs. Some tax reform proposals include other changes to try to mitigate this effect. Chairman Camp, for example, proposes a 25 percent rate for pass-throughs engaged in domestic manufacturing. That matches the 25 percent corporate rate in his plan and is lower than the 35 percent top rate that would otherwise apply to pass-through earnings in his proposal.

- Some reforms could reduce the compliance burden on small businesses. Chairman Camp, for example, proposes to expand the use of cash accounting for businesses whose revenues have averaged less than $10 million in the past three years. This simplification would be partly offset, however, by the requirement that some larger firms—personal service corporations with revenues above $10 million—use accrual accounting.

- To raise revenue or pay for rate reductions, policymakers may reduce or eliminate some existing tax breaks that specifically benefit small business. Chairman Camp, for example, would replace graduated corporate rates—which now start as low as 15 percent—with a flat 25 percent rate, and would eliminate the favorable capital gains treatment for investments in small businesses.

- Other reductions in tax breaks would hit larger businesses and thus increase the relative advantage given to smaller ones. For example, Chairman Camp proposes to require the capitalization and amortization of 50 percent of advertising expenses, but would exempt up to $1 million in advertising costs for firms with no more than $1.5 million in total advertising. That safe harbor gives a relative advantage to small firms with limited advertising budgets. Camp would also make depreciation allowances less favorable for capital investments. Lengthening of depreciation schedules would increase the value of the relief offered by Section 179 expensing.

Thank you again for inviting me to appear today. I look forward to your questions.

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National Association for the Self-Employed
325 7th Street, NW, Suite 250
Washington, DC 20004
P: 202-466-2100
F: 202-466-2123
www.NASE.org

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Statement for the Record
Submitted to the Committee on Small Business
United States House of Representatives
Washington, D.C.

Submitted by Katie Vlietstra
Vice-President of Government Relations & Public Affair
National Association for the Self-Employed
April 9, 2014

The National Association for the Self-Employed (NASE) respectfully submits this official statement for the record on today's hearing, "The Biggest Tax Problems for Small Businesses." The NASE represents the 23 million self-employed and micro-business owners (10 employees or fewer), as well as providing educational resources for those looking to start and grow their businesses. Founded in 1981, the association has been the leading voice advocating for America's smallest businesses in all areas of public policy, especially in the area of tax inequities faced by the self-employed.

For background purposes, we would like to put into context the role of the self-employed in the larger small-business community. At present, there are roughly 27 million small businesses nationwide, ranging from 1 to 499 employees and of those, 23 million are identified as self-employed, accounting for more than 78 percent of the entire small-business community. These self-employed businesses generate roughly $950 million dollars annually in sales (2010 Non-Employer Statistics, U.S. Census Bureau). The majority of the self-employed, roughly 56 percent, have their business organized as a sole-proprietorship. Thus, any significant tax reform in the corporate area will have little if any impact on the self-employed.

On behalf of our members, the NASE is strongly in favor of comprehensive tax reform. In a 2012 survey, 78 percent of our members, nationwide, voiced their overwhelming support for tax reform. So strong is the call for reform that in 2012, 96 percent of our members deemed individual and corporate tax reform as a "very important or moderately important" issue for Congress to address in 2013. Reform of the tax code is essential in order to create a simplified system that treats all businesses fairly by removing unnecessary hurdles and streamlining a cumbersome and overwhelming filing process.

Yet lawmakers largely ignore the self-employed in proposed reforms. For the past several years the House Ways and Means Committee has undertaken a valiant effort to draft and propose significant tax reform. However, those efforts are seemingly void of any proposals that would address the continued disparity faced by the self-employed under the current tax code. In blunt terms, only one of the four components has any bearing on the self-employed community, the Unified Deduction for Start-Up and Organization Expenses. And it is ironic that the framework for the unified deduction is included in H.R. 886, Small Business Tax Relief Act of 2013, which also contains an additional six other tax measures that the small-business draft overlooks (Note: the small business draft does include the permanent expensing provision which is included in H.R. 866).

The following are real, actionable tax reform recommendations that would have significant, positive impact on the self-employed:

- Deduction of health insurance costs for the self-employed as a qualified business expense by adding a line item on the Schedule C form and not on page one of Form 1040. The biggest tax inequity faced by the self-employed continues to be their inability to deduct the cost of the health insurance as a qualified business expense. This amounts to roughly $1,800 in additional taxes per year for self-employed individuals.

    - Amend the definition of "employee" to include the owner and spouse of a sole proprietorship, or a 2 percent or greater shareholder in an S Corporation—a simple legislative or administrative fix to current language. This would address many issues related to "fringe benefits," for example: the applicability of an HRA 105 plan, retirement plan contributions, and health insurance premiums.

- Simplified and streamlined definition of independent contractor versus employee by expanding the Form 1099 that requires the owner and contractor to agree to their business relationship in a transparent manner. Resulting in a reduction of abuse by business owners and their use of independent contractors.

- Reforms to the Affordable Care Act that would make the purchase of health care coverage simpler and more cost effective for the self-employed. Two proposal: changing the premium assistance calculation from anticipated gross income to adjusted gross income from the previous year (utilizing safe harbor provisions that already excited for the self-employed by the IRS) and reversing the Technical Release No. 2013–03, "Application of Market Reform and other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain other Employer Healthcare Arrangements," so that micro-business owners may utilize health reimbursement arrangements for help their employees cover related medical out-of-pocket expenses.

It goes without saying that any significant reform to the tax code will be challenging, but we believe that putting forth a dynamic, common-sense proposal for bringing the tax code into the 21st Century can be accomplished. Any such proposal must provide for a transformational change to all aspects of the tax code, individual and corporate.

As it stands now, the self-employed continue to face a significant inequity when it comes to adhering to the current dysfunctional and byzantine tax code. We believe it is time for Congress to act.

We look forward to continuing to work with the Small Business Committee on removing the barriers to self-employment by making the tax code simpler, easier and more business friendly.

The Leader in the Financial Analysis of Privately Held Companies

Sageworks, Inc.
5565 Centerview Drive
Raleigh, NC 27606

P 919.851.7474
F 919.851.6718
www.sageworks.com

sageworks

April 11, 2014

Chairman Sam Graves
House Small Business Committee
2361 Rayburn House Office Building (RHOB)
Washington, D.C. 20515

Dear Mr. Chairman and members of the Committee,

My name is Brian Hamilton, the chairman and co-founder of Sageworks, the leader in the financial analysis of privately held U.S. companies. In light of the Committee's hearing this week on *The Biggest Tax Problems for Small Businesses,* I thought it might be helpful to lend some thoughts and perspective on the mindset of business owners, how they operate, and the challenges they face related to administrative burden. Before we make policy, I believe that it's essential that we get into the heads of these business owners.

When we think of the term "business," we tend to think of it as a broad category. However, there's a fundamental divide within this broad category that often gets glossed over. I think that this divide is especially relevant when discussing policy issues, like the tax code and its complexity, that impact business owners' bottom line.

Although people are cognizant of the differences between a publicly traded firm and a privately held one, they tend to think of the category as being under the same approximate "business" tent. Yet, the difference between these types of organizations is so wide that the organizations don't remotely resemble one another. For example, when you look at the profits of a publicly traded firm, those profits are distributed amongst shareholders in the form of dividends. When you look at the profits of most privately held companies, those profits are also distributed to the owners, but there's a massive difference in the use of earnings. Many stakeholders in publicly traded companies use profits or dividends as extra income or as part of an investment plan; stakeholders of privately held companies use profits to pay personal bills, as these profits are their only source of income. For an owner, profitability allows them to, literally, put bread on the table. For public company stakeholders, profits are usually icing on the cake.

This distinction will logically make sense to most individuals, but it is almost impossible to understand the cascading effects of this concept for those who have not run businesses. If an owner of a privately held company has profits of $2,000 per month and his or her recurring personal bills and expenses are $1,500, then that $500 in extra money is what the business owner uses to eat, buy gas, and cover other expenses. This money is more than a line on a financial statement. Being in

the red, for private companies, indicates a direct, negative impact on the disposable income and livelihood of the company's stakeholders.

The gap between little league baseball and major league baseball is wide but not close to the difference between small companies and large ones. After all, baseball is still baseball with largely fixed rules and even dimensions. But, every aspect of running a private company is different from running a publicly traded firm. I'm worried that, often, policies are designed for the broad category "business," with only small variances allowed for "small business." Yet, the differences of category are too large for this type of thinking.

With this distinction in mind, some of the statistics cited in yesterday's hearing become even more troubling: 40 percent of small businesses saying they spend upwards of 80 hours dealing with taxes, according to the NSBA.[1] Those are 80 hours that businesses lose from generating revenue and profits; 80 hours of food off the table. Also, as cited by Mr. Reynolds yesterday[2], the vast majority of small businesses are spending money hiring an external tax specialist to help them with preparations.

This might be all be fine if private businesses were tremendously profitable and had resources available to contract out this burden. They do not. According to our proprietary database and research at Sageworks, we know that the average net profit margin of a privately held company in the U.S. is between 3 and 7 percent[3]; for every dollar in sales, a business is earning only 3 to 7 cents in profit. In some cases, in industries like retail, those margins are much slimmer. With razor thin bottom lines, the loss of time and money can be very damaging to smaller businesses.

Any additional administrative burden whatsoever- not just related to tax compliance- creates more burden on the owner of a private company. It would be almost impossible that extra taxes and administrative burden would not have a significant and adverse effect on a company's ability to grow and hire employees. Hopefully, equipped with an understanding of the mindset of these business owners, as well as an awareness of the seismic distinction between large public companies and smaller private companies, the Committee may advocate for legislation that reduces the administrative burden for the 28 million small and privately held businesses in the country.[4]

Sincerely,

Brian Hamilton
Chairman and Co-founder of Sageworks
Brian.Hamilton@Sageworks.com

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[1] NSBA 2014 Small Business Taxation Survey
[2] Testimony of Tim Reynolds, House Committee on Small Business Hearing: "The Biggest Tax Problems of Small Business."
[3] According to the Sageworks Private Company Database, a proprietary source of private company financial statement information
[4] SBA- "Frequently Asked Questions," http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf